

SEC Issues Final Rules for Compensation Committee and Adviser Independence Standards

On June 20, 2012, the Securities and Exchange Commission adopted final rules directing the national securities exchanges to amend their listing standards to require public companies to satisfy new independence requirements for their board compensation committees to maintain their listing status. The final rules are substantially similar to the proposed rules originally issued by the SEC on March 30, 2011 (which were summarized in our previous [Thoughtful Pay Alert](#) published on April 5, 2011) and continue to leave to the national securities exchanges the determination of the important details for compliance.

Section 952 of the Dodd-Frank Act required the SEC and the national securities exchanges to adopt rules to enhance the independence of board compensation committees and to require such compensation committees to assess the independence of any compensation consultant, legal counsel, or other adviser. Section 952 also directed the SEC to adopt new disclosure rules concerning the identity and engagement of compensation consultants.

Background

To provide greater assurances as to the integrity of the executive compensation-setting process, Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added new Section 10C to the Securities Exchange Act

Five Things You Should know about the SEC's Final Rules on Compensation Committee and Adviser Independence

- ▶ Although the final rules do not elaborate on the "independence" factors (set forth below) which are specifically identified in Section 952 of the Dodd-Frank Act, they add one additional independence factor to those previously identified - whether there is any business or personal relationship between the company's executive officers and a potential adviser to the compensation committee. Surprisingly, the SEC has delegated responsibility for explaining (and possibly supplementing) these factors to the national securities exchanges (that is, the NYSE, the Nasdaq, and the AMEX).
- ▶ The national securities exchanges must modify their listing standards to require that the members of the compensation committees of listed companies be directors and independent. In defining "independence," the exchanges are to consider such factors as the source of the compensation received by the director, including any consulting fees, and whether the director is affiliated with the company.
- ▶ The national securities exchanges must also modify their listing standards to require that the compensation committees of listed companies consider the independence of a potential adviser to the committee (such as a compensation consultant or legal counsel) before engaging such adviser. Notably, compensation committees are not required to use independent advisers.
- ▶ The final rules require all companies (not just listed companies) in any proxy statement filed in connection with an annual meeting of shareholders at which directors will be elected which occurs on or after January 1, 2013, to disclose: (i) whether the compensation committee retained or obtained the advice of a compensation consultant; (ii) whether the work of the consultant raised any conflicts of interest; (iii) if so, the nature of the conflict; and (iv) how the conflict of interest is being addressed.
- ▶ The national securities exchanges have until September 25, 2012 to submit their proposed listing standards to the SEC. The new listing standards (as described in Section 952 of the Dodd-Frank Act and the final rules) must become effective by June 27, 2013.

SEC Issues Final Rules for Compensation Committee and Adviser Independence Standards (continued)

of 1934. Among other things, Section 10C is intended to strengthen the independence of board compensation committees, ensure that compensation committees consider the independence of their advisors as part of the engagement process, and provide greater transparency about any conflicts of interest arising as a result of the committee's retention of a compensation consultant.

Although Section 10C directed the SEC to finalize its rules directing the national securities exchanges to modify their listing standards to prohibit the listing of any company that fails to comply with these requirements by July 2011, the Commission didn't complete its rulemaking until last month. On June 20, 2012, the SEC adopted final rules directing the national securities exchanges to amend their listing standards to reflect the independence requirements of Section 10C. Consequently, the earliest that the requirements will be in effect (if then) is the 2013 proxy season.

Compensation Committee Independence

Section 10C requires the SEC to direct the national securities exchanges to prohibit the listing of any company issuing equity securities (with certain limited exceptions, including controlled companies, smaller reporting companies, and certain foreign private issuers) unless all of the members of its compensation committee (or committee performing equivalent functions) are directors and meet specific independence standards.

The SEC's final rules implement this requirement. The final rules also extend the independence requirements, in the situation where no compensation committee (or other board committee performing such functions) exists, to individual directors responsible for a compensation committee's typical duties.

The exchanges are free to consider any relevant factors in formulating their "independence" definition as long as they consider the factors set forth in Section 952 and the final rules – the source of compensation received by a director, including any consulting fees, and whether the director is affiliated with the company, any subsidiary, or an affiliate of any subsidiary.

Under the final rules, controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies registered

Key Takeaways from the SEC's Final Rules

- ▶ The National Securities Exchanges have until September 25, 2012 to propose actual rules for independence of compensation committee members and its advisors
- ▶ The new disclosure requirement concerning compensation consultant conflicts of interest will apply to 2013 proxy statements

under the Investment Company Act of 1940, foreign private issuers that disclose annually why they do not have an independent compensation committee, and smaller reporting companies are exempt from the compensation committee independence requirement.

Finally, companies will be given a reasonable opportunity to reconstitute their compensation committees before being delisted due to any failure to satisfy the independence requirement. Also, the final rules require the national securities exchanges to provide that if a compensation committee member ceases to be independent for reasons beyond his or her control, the member may, after the company gives notice to the appropriate national securities exchange, remain a compensation committee member until the earlier of the next annual shareholder meeting or one year from the occurrence of the event that caused the member to no longer be independent.

Observations

While, at this point, it is difficult to predict how the national securities exchanges will define "independence," the formulation will be particularly important to directors who represent shareholders that are affiliates of a company, such as venture capital or private equity investors. The final rules specifically provide that the exchanges may exempt certain relationships from the independence requirement, and it's expected that serious consideration will be given to exempting directors affiliated with such investors since their interests are congruent with those of other investors.

In addition, the final rules do not require any look-back period with respect to relationships which might have existed prior to any individual joining a compensation committee. Consequently, we expect the national securities exchanges will exercise the flexibility provided by the rules

SEC Issues Final Rules for Compensation Committee and Adviser Independence Standards (continued)

to fashion an independence definition that enhances their existing requirements in this area and works for a wide range of companies.

Compensation Committee Adviser Independence

Section 10C also requires the SEC to direct the national securities exchanges to prohibit the listing of any company issuing equity securities (with the limited exceptions as noted above) unless, before selecting a compensation consultant, legal counsel, or other adviser, the compensation committee first considers the prospective adviser's independence. This evaluation must take into account the following factors, which are to be competitively neutral:

- Whether the firm that employs the compensation consultant, legal counsel, or other adviser provides any other services to the company;
- The amount of fees received from the company by the firm that employs the compensation consultant, legal counsel, or other adviser (calculated as a percentage of that firm's total revenue);
- The policies and procedures of the firm that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and
- Whether the compensation consultant, legal counsel, or other adviser owns any stock of the company.

The final rules add a sixth factor which must be included in this evaluation:

- Any business or personal relationship of the compensation consultant, legal counsel or other adviser with any executive officer of the company.

As noted in the final rules, these factors distinguish between the individual providing advice to the compensation committee and the firm that employs the individual. Thus, where appropriate the assessment of relationships will need to consider both the individual providing the advice as well as the firm employing the adviser.

The final rules also indicate that, as part of this evaluation, the compensation committee is to consider any other fac-

tors identified by the national securities exchange before engaging a compensation consultant, legal counsel, or other adviser to assist on compensation-related matters. Interestingly, the final rules (just like the proposed rules) do not elaborate on the meaning or scope of any of the enumerated factors or the additional factor. This work is being left to the exchanges. In addition, under the final rules, the national securities exchanges also have the authority to exempt certain categories of companies from this independence assessment requirement.

Observations

Consistent with Section 10C, the final rules make clear that compensation committees are free to engage compensation consultants, legal counsel, and other advisers as they see fit, as long as they have considered any potential conflict of interest and taken steps to minimize any potential conflict of interests in advance. Thus, it is left to the company – and its shareholders – to decide whether a compensation consultant, legal counsel, or other adviser is an appropriate adviser to the compensation committee.

As for the factors that are to be considered in evaluating the independence of a compensation consultant, legal counsel, or other adviser, it will be up to the exchanges to determine how they are to be construed. This will necessitate several tricky interpretive issues, such as what it means to “provide advice” to the committee and, in this context, what type of information constitutes “advice.” Presumably, the public will be given an opportunity to comment on the proposed scope of these factors before they are approved. For example, we expect that the exchanges are likely to clarify that “business or personal relationships” do not include situations where a compensation committee member serves on the compensation committee of a second company that has previously engaged the compensation consultant being evaluated.

Retention of Advisers

Section 10C also confirms the authority of the compensation committee to retain and oversee the work of a compensation consultant, legal counsel, and other adviser and directs companies to provide appropriate funding for these engagements. The statute also grants the national securities exchanges the authority to exempt certain categories of companies, including smaller reporting companies, from these requirements. The final rules clarify that these provisions apply only to compensation consultants, legal counsel

SEC Issues Final Rules for Compensation Committee and Adviser Independence Standards (continued)

and other advisers retained by the compensation committee (rather than any such adviser retained by the company or senior management directly).

Conflicts of Interest Disclosure

Finally, Section 10C directs the SEC to amend its rules to require companies to disclose in their proxy statements for annual meetings of shareholders at which directors will be elected which occur on or after January 1, 2013, whether the compensation committee has engaged a compensation consultant, whether the consultant's work has raised any conflict of interest, and, if so, the nature of the conflict and how it is being addressed.

Observations

Originally, the SEC had planned on integrating this new disclosure requirement with its existing requirements that companies disclose their use of compensation consultants and provide detailed fee information where a consultant provides both compensation-related services and non-compensation-related services to the compensation committee or the company.

Instead, the final rules provide for a separate rule which requires all companies (not just listed companies) to disclose whether a conflict of interest exists, the nature of the conflict and how it is being addressed for any compensation consultant identified in the SEC's existing disclosure regime, regardless of whether such compensation consultant was retained by senior management, the company directly or the compensation committee. This approach has the effect of preserving the existing broad-based plans exception, under which disclosure is not required in the case of a compensation consultant engaged solely in connection with non-discriminatory, broad-based plans or engaged to provide non-customized benchmark or survey data.

Although the SEC had solicited comment on whether this disclosure requirement should be extended to legal counsel or other advisers, as set forth in the final rules it is limited solely to compensation consultants.

Exemptions

Consistent with Section 10C, the listing standard requirements for compensation committee and adviser independence will not apply to controlled companies, smaller reporting companies, issuers of securities futures products

cleared by a registered clearing agency or a clearing agency exempt from registration, or registered clearing agencies that issue standardized options.

However, the rules governing the disclosure of compensation consultant conflicts of interest continue to apply to all companies subject to the proxy rules, including controlled companies and smaller reporting companies.

Compliance Dates

Listing Standards

The final rules require the national securities exchanges to:

- submit their proposed listing standards to the SEC by September 25, 2012, and
- have their proposed listing standards approved by the SEC no later June 27, 2013.

Disclosure Requirements

The new SEC disclosure requirements apply to proxy statements filed in connection with an annual meeting of shareholders at which directors will be elected occurring on or after January 1, 2013.

Compensia's Commitment to Our Clients

We recognize that the value and integrity of our client's executive compensation actions and decisions are dependent on the compensation committee having access to candid, impartial advice and analysis provided by an adviser that is free from any conflicts of interest. As a trusted adviser to compensation committees, we strive to ensure that our services are conducted in an impartial and objective manner. In furtherance of this commitment, we maintain internal policies and practices designed to safeguard our independence.

About the Authors

The authors of this Thoughtful Pay Alert are Ralph Barry and Mark Borges, principals at Compensia. If you have any questions about this Thoughtful Pay Alert, Ralph can be reached at 408.907.4320 or rbarry@compensia.com and Mark can be reached at 415.462.2995 or mborges@compensia.com. ■

SEC Issues Final Rules for Compensation Committee and Adviser Independence Standards (continued)**About Compensia**

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

San Francisco

1550 Bryant Street
Suite 740
San Francisco, California 94103
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Anna-Lisa Espinoza
alespinoza@compensia.com
858.509.1179

Mathew T. Quarles
mquarles@compensia.com
323.919.7338