

Client Alert

SEC Issues Final Rules on Independence of Compensation Committees and Their Advisers

EXEQUITY

Independent Board and
Management Advisors

On June 20, 2012, the Securities and Exchange Commission (the “SEC”) issued final rules to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which added Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”).¹ Generally, the final rules adopted by the SEC mirror the proposed rules, with some minor modifications, which we detail below.

Listing Standards Relating to Compensation Committees

Section 10C requires the SEC to issue final rules that direct the national securities exchanges and national securities associations to prohibit the listing of an equity security if the company is not in compliance with the following provisions of Section 10C and the SEC’s implementing rules:

- **Independence of Compensation Committee Members**—Each member of the compensation committee of the board must be a member of the board of directors and must be independent. The national securities exchanges are required to develop a definition of independence after considering relevant factors, including the following two factors:
 - The source of compensation of a board member, including any consulting, advisory, or other compensatory fee paid by the company to the board member; and
 - Whether the board member is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

This rule applies to any committee that performs functions typically performed by a compensation committee, whether or not the committee performs other functions or is formally designated as a compensation committee. In the final rules, the SEC extended the committee independence requirements to apply to those members of a company’s board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of a board committee.²

¹ See SEC Press Release 2012-115, June 20, 2012, <http://www.sec.gov/news/press/2012/2012-115.htm>; SEC Release Nos. 33-9330; 34-67220; File No. S7-13-11, available at: <http://www.sec.gov/rules/final/2012/33-9330.pdf>.

² The requirements relating to consideration of a compensation adviser’s independence and to responsibility for the appointment, compensation, and oversight of compensation advisers also apply to the members of the board, who in the absence of a board committee, oversee executive compensation.

- **Authority of Compensation Committee and Funding**—The compensation committee has the sole discretionary authority to retain or obtain the advice of an adviser, and is directly responsible for the appointment, compensation, and oversight of the adviser’s work. In addition, the compensation committee must be provided with appropriate funding for payment of reasonable compensation to the compensation consultant, independent legal counsel, or any other adviser retained by the compensation committee. The authority and funding requirements apply only to advisers **retained** by the compensation committee, and not to any adviser to the committee.

- **Selection of Compensation Consultant, Legal Counsel, and Other Advisers**—The compensation committee may only select a compensation consultant, legal counsel, or other adviser (collectively, the “advisers”) after consideration of a minimum of six specified independence factors:
 - The provision of other services to the company by the person that employs the adviser (the “advisory firm”);
 - The **amount** of fees received from the company by the advisory firm as a percentage of the advisory firm’s total revenue;
 - The policies and procedures the advisory firm has in place to prevent conflicts of interest;
 - Any business or personal relationship of the adviser with a member of the compensation committee;
 - Any stock of the issuer owned by the adviser; and
 - Any business or personal relationship between the executive officers of the company and the compensation adviser or the advisory firm.

The first five factors are identical to those set out in Exchange Act Section 10C(b), while the sixth factor was added by the SEC in the final rules. The final rules also emphasize that these factors should be considered in their totality and that no one factor should be viewed as a determinative factor of independence.

The final rules do not define the phrases “business or personal relationship” or “provision of other services.” However, the commentary states that a business or personal relationship between the executive officers of the company and the compensation adviser or the advisory firm includes familial relationships and business partnerships. This may imply that a business or personal relationship can be narrowly construed. It may also mean that the SEC is leaving these phrases to the exchanges to define. However, we believe that the SEC may not have defined these phrases because the determination should be based on an analysis of all the facts and circumstances, and the compensation committee’s judgment and interpretation.

The final rules also clarify that the compensation committee must consider the independence of any compensation consultant, legal counsel, or other adviser, including those retained by management if advice is provided to the compensation committee. However, the compensation committee need not consider the six independence factors before consulting with or obtaining the advice from in-house counsel.

It is important to note that the SEC does not preclude a compensation committee from hiring a compensation consultant or adviser that is not independent; however, hiring a nonindependent compensation consultant may result in the disclosure of a conflict of interest, as discussed later in this **Client Alert**.

The final rules do not address whether the selection of an adviser before their effective date would require compensation committees to reevaluate the selection based on consideration of the specified independence factors. Exequity believes that since this rule is designed to affect the listing of securities on an initial and ongoing basis, it would be an odd result if compensation committees did not have to reevaluate their adviser(s) in light of the final listing standard requirements.

- **Exempted Entities**—The following entities will not be required to comply with the final rules on compensation committee independence:

- Limited partnerships;
- Companies in bankruptcy proceedings;
- Open-end management investment companies registered under the Investment Company Act of 1940; and
- Any foreign private issuer that discloses in its annual report the reasons that it does not have an independent compensation committee.

The national securities exchanges can also exempt particular relationships from the independence requirements applicable to compensation committee members.

Finally, several groups of companies will be completely exempted from all of the requirements under the final rules with respect to the listing standards relating to compensation committees:

- Controlled companies (listed public companies having more than 50% of their voting power for the election of directors held by an individual, a group, or another company);
- Smaller reporting companies (a public company that is not an investment company, an asset-backed entity, or a majority-owned subsidiary of a parent that is not a smaller reporting company and that has a public float of less than \$75 million, and, if \$0 of public float then has annual revenues of less than \$50 million); and
- Other categories of companies exempted by the national securities exchanges.

Compensation Consultant Disclosure and Conflicts of Interest

For any compensation consultant that is identified under existing Item 407(e)(3)(iii),³ the final rules require disclosure if the work of the consultant raised any conflict of interest. If a conflict of interest is raised, the company must disclose the nature of the conflict and how the conflict is being addressed. In deciding whether there is a conflict of interest that may need to be disclosed, companies should, at a minimum, consider the six independence factors discussed above. If a conflict of interest is not raised, it is our understanding that the disclosure would need to state that no conflict is raised.

In the proposed rules, the SEC acknowledged that a compensation committee may be unable or reluctant to definitively conclude whether a conflict of interest exists, and requested comment on whether the rules should also include the appearance of a conflict of interest in the interpretation of what constitutes a conflict of interest. Based on comments received, the SEC decided not to extend the disclosure requirement to potential conflicts of interest or appearances of a conflict of interest. Also, the final rules retain the exemption for compensation consulting services involving only broad-based, nondiscriminatory plans and the provision of noncustomized survey data from the compensation consultant disclosure requirements, including the new conflicts of interest disclosure.

The disclosure requirements apply to **all** companies subject to the proxy rules, including controlled companies, nonlisted issuers, and smaller reporting companies.

Timing

The final rules become effective July 27, 2012 and require the national securities exchanges to provide to the SEC proposed rule changes that comply with the SEC's final rules no later than September 25, 2012. Final rules must be approved by the SEC no later than June 27, 2013.

In any event, the disclosure provisions of the final rules regarding compensation consultant conflicts of interest (new Item 407(e)(3)(iv)) will apply to any proxy or information statement for an annual meeting of shareholders (or special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013.

Exequity's Comments on the SEC's Final Rules

The SEC's final rules add little to the statutory requirements set forth in Exchange Act 10C. In fact, the SEC's final rules essentially "punt" any substantive rulemaking to the exchanges. Thus, until the exchanges provide their proposed rule changes, the full extent of the requirements relating to compensation committee and adviser independence is unknown.

Likely, the most challenging aspect of the final rules to implement will be the disclosure regarding the compensation consultant and any conflict of interest. As we stated, the SEC elected not to define some of the ambiguous language in the statute (i.e., "other services" or what constitutes a "business or personal relationship"). For example, is it possible for a conflict of interest to exist if a compensation committee member or executive officer refers the compensation consultant to another company he/she serves either as a compensation committee member or as an executive officer? We believe this is unlikely to be

³ Item 407(e)(3)(iii) requires disclosure of any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. Companies must identify the consultants, state whether such consultants were engaged directly by the compensation committee or any other person, describe the nature and scope of the consultants' assignment and the material elements of any instructions given to the consultants under the engagement, and disclose the aggregate fees paid to a consultant for advice or recommendations on the amount or form of executive and director compensation and the aggregate fees for additional services if the consultant provided both and the fees for the additional services exceeded \$120,000 during the fiscal year.

considered a “business or personal relationship” which may rise to the level of a conflict of interest; however, every compensation committee will need to consider all of the facts and circumstances to make that determination.

The Appendix provides a summary, in chart form, of the requirements of Exchange Act Section 10C and the SEC’s final rules.



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Appendix: Summary of Requirements of Exchange Act Section 10C and the SEC’s Final Rules

Provision	Exchange Act 10C Statutory Requirements	SEC’s Final Rules
<p>General Rule/Applicability</p> <p><i>Exchange Act §10C(a)(1), (a)(4), (f)(1), (f)(3), (g)</i></p>	<ul style="list-style-type: none"> • 10C(a) states that companies listed on a national securities exchange or national securities association would have equity securities delisted if issuer does not comply with the compensation committee independence requirements of Section 10C; however, 10C(f)(1) states that delisting would apply to any security if the issuer is not in compliance with all the requirements of Section 10C. • Certain issuers are exempt from compensation committee independence requirements. • Rule permits the exchanges to exempt a particular relationship from the compensation committee independence requirements or to exempt any category of issuer from the requirements of 10C. • Controlled companies are exempt from all requirements of 10C. 	<ul style="list-style-type: none"> • Final Rules 10C-1(a)(1) and (2) implement the delisting requirement. • SEC’s final rules provide that all of the requirements of the final rules apply only to issuers with listed equity securities; thus, companies with only listed debt securities are not subject to Section 10C’s or the final rules’ requirements. • Securities futures products and traded option contracts issued or cleared by a clearing agency are exempt from the definition of an equity security. • Leaves exemption authority to the exchanges, subject to the SEC’s approval. <p>SEC Commentary</p> <ul style="list-style-type: none"> • There are no national securities associations that currently list equity securities. • SEC notes that foreign private issuers are exempt from the compensation committee independence requirements but are not exempt from the provisions related to adviser independence (however, foreign private issuers are not subject to the proxy rules and thus would not be subject to the disclosure requirements). • “Compensation committee” is defined as (1) a committee designated as the compensation committee, (2) any committee that performs functions typically performed by a compensation committee, even if the committee is not designated as the compensation committee or performs other functions, and (3) except for the requirements that the compensation committee must have discretion to retain a compensation consultant, independent legal counsel, and other compensation advisers, and must be provided with appropriate funding, members of a company’s board of directors who oversee executive compensation matters on behalf of the

Provision	Exchange Act 10C Statutory Requirements	SEC's Final Rules
		<p>board of directors (in the absence of a board committee).</p> <ul style="list-style-type: none"> • NYSE requires issuers to have a compensation committee; however, NASDAQ does not, and the SEC's final rules do not require the establishment of a compensation committee.
<p>Opportunity to Cure Defects</p> <p><i>Exchange Act §10C(f)(2)</i></p>	<ul style="list-style-type: none"> • The SEC will provide for procedures for a company to have an opportunity to cure any defects before a delisting is imposed. 	<ul style="list-style-type: none"> • Final Rule 10C-1(a)(3) would provide that exchanges may provide that if a member of the compensation committee ceases to be independent for reasons outside of his control, that person (with notice to the exchange) can remain on the compensation committee until the earlier of the next annual meeting or one year from the event that caused the member to no longer be independent. <p>SEC Commentary</p> <ul style="list-style-type: none"> • SEC believes exchanges' current procedures to cure defects would satisfy the requirement to provide an opportunity to cure defects.
<p>Independence of Compensation Committee Members</p> <p><i>Exchange Act §10C(a)(2) and (a)(3)</i></p>	<ul style="list-style-type: none"> • Each member of the compensation committee must be a member of the board of directors and be independent. • In determining the definition of independence, the national securities exchanges must consider relevant factors, including: <ul style="list-style-type: none"> — The source of compensation of a member of the board, including any consulting, advisory, or other compensatory fees paid; and — Whether a member of the board is affiliated with the issuer, a subsidiary, or an affiliate of a subsidiary. 	<ul style="list-style-type: none"> • The SEC's final rules do not specify any additional factors that the exchanges must consider in determining independence (Final Rule 10C-1(b)(1)). • "Affiliate" not defined. • Difference from audit committee requirements is that the exchanges have more discretion to determine the independence standards for compensation committee members than for audit committee members. The Exchange Act prescribes certain minimum independence criteria for audit committee members and states that certain relationships preclude independence. With respect to compensation committee members, these relationships must only be considered (and do not necessarily preclude independence).

Provision	Exchange Act 10C Statutory Requirements	SEC's Final Rules
<p>Authority of Compensation Committee</p> <p><i>Exchange Act §10C(c), (d), (e)</i></p>	<ul style="list-style-type: none"> • Compensation committee has sole discretion to retain or obtain the advice of advisers (compensation consultant, legal, and other advisers). • Compensation committee must be directly responsible for appointment, compensation, and oversight of adviser's work. • Compensation committee not required to implement or act consistently with adviser's advice. • Does not impact the ability of the compensation committee to exercise its own judgment. • Listed companies must provide appropriate funding for payment of reasonable compensation to the adviser. 	<ul style="list-style-type: none"> • Repeats statutory requirements (Final Rules 10C-1(b)(2) and (3)). <p>SEC Commentary</p> <ul style="list-style-type: none"> • Companies are not required to hire independent advisers. • Compensation committees are not precluded from using nonindependent or in-house advisers.
<p>Selection of Compensation Committee Advisers—Independence Factors</p> <p><i>Exchange Act §10C(b)</i></p>	<ul style="list-style-type: none"> • Adviser can only be selected after consideration of independence factors identified by the SEC, which must be competitively neutral among categories of advisers and preserve the ability of the compensation committee to retain members from any category. This consideration must include, at a minimum, the following factors: <ul style="list-style-type: none"> — Other services provided to the company by the advisory firm; — Fees received from the company by the advisory firm as a percentage of the advisory firm's total revenue; — Policies and procedures of the advisory firm that are designed to prevent a conflict of interest; — Any business or personal relationship of the adviser with a member of the compensation committee; and — Any stock of the company owned by the adviser. 	<ul style="list-style-type: none"> • Repeats statutory requirements (Final Rule 10C-1(b)(4)). • Adds one additional factor to be considered—any business or personal relationship of the compensation adviser or the person employing the adviser with an executive officer of the company. <p>SEC Commentary</p> <ul style="list-style-type: none"> • Applies to any compensation consultant, legal counsel, or other adviser, but specifically excludes in-house legal counsel. • Listing standards developed by the exchanges must not include any materiality, bright-line thresholds, or cut-offs (e.g., listing standards cannot implement a requirement that the compensation committee must consider a factor only if the materiality threshold is exceeded). • Exchanges can add other independence factors and these factors may include materiality or bright-line thresholds. • SEC did not address what constitutes a "business" or "personal relationship." • "Other services" is not defined. • SEC decided not to require the compensation committee to disclose its process for selecting advisers.

Provision	Exchange Act 10C Statutory Requirements	SEC's Final Rules
<p>Compensation Consultant Disclosure and Conflicts of Interest</p> <p><i>Exchange Act §10C(c)(2)</i></p>	<ul style="list-style-type: none"> • In any proxy for an annual meeting (or special meeting in lieu of an annual meeting), company must disclose: <ul style="list-style-type: none"> — Whether the compensation committee retained or obtained the advice of a compensation consultant; and — Whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. 	<ul style="list-style-type: none"> • Final rules found that the majority of the 10C(c)(2) requirements were satisfied by the current disclosure requirements in Item 407(e)(3) of Regulation S-K. New Item 407(e)(3)(iv) of Regulation S-K requires that if any compensation consultant that is disclosed as a result of Item 407(e)(3)(iii) and whose work raised any conflict of interest, the company must disclose the nature of the conflict and how it is being addressed. • “Conflict of interest” is not defined; however, instruction provides that the six factors to be considered before selecting a compensation consultant are among the factors that should be considered in determining whether there is a conflict of interest that may need to be disclosed. • Compensation consulting work limited to consulting on broad-based plans and providing noncustomized benchmark data does not raise conflict of interest concerns and thus, is exempted from the disclosure requirements, including the conflict of interest disclosure. • Applies to all companies subject to the proxy rules, including controlled companies, nonlisted issuers, and smaller reporting companies. • Item 407(e)(3) currently requires disclosure in the proxy for an annual meeting at which directors are elected, any role of compensation consultants in determining or recommending executive and director compensation, including: <ul style="list-style-type: none"> — Identifying the consultants; — Stating whether the consultants are engaged directly by the compensation committee or any other person; — Describing the nature and scope of the consultants’ assignment, and material elements of any instructions given to the consultants; — Disclosing the aggregate fees paid to the consultant for advice on executive compensation services and the aggregate fees for additional services if the consultant provides both, and the fees for the additional services exceed \$120,000; and

Provision	Exchange Act 10C Statutory Requirements	SEC's Final Rules
		— Consulting on nondiscriminatory, broad-based plans or providing noncustomized information or information that is customized based on parameters that are not developed by the compensation consultant and about which the compensation consultant does not provide advice are exempt from being considered executive compensation services.