

SEC Adopts Final Rules Regarding Compensation Committees and Compensation Advisors

Last week, the Securities and Exchange Commission (“SEC”) adopted final rules (the “Final Rules”) that direct the national securities exchanges (the “exchanges”) and national securities associations to establish certain listing standards related to the independence of compensation committees and their compensation advisers.¹ The Final Rules will also require new disclosures in proxy statements concerning the use of compensation consultants and related conflicts of interest. The new rules implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which added Section 10C to the Securities Exchange Act of 1934 (“Exchange Act”).² Like the proposed rules issued by the SEC last year, the Final Rules largely mirror the relevant Dodd-Frank statutory requirements and delegate to the exchanges the task of developing their own rules.³

I. Applicability of Listing Standards

The Final Rules direct the exchanges to adopt listing standards that apply to any committee of the board that performs functions typically performed by a compensation committee, including oversight of executive compensation, whether or not such committee also performs other functions or is formally designated as a compensation committee. In addition, the listing standards adopted by the exchanges must also apply, with limited exceptions, to the members of a listed issuer’s board of directors who, in the absence of a board committee, oversee executive compensation matters on behalf of the board of directors.

II. Compensation Committee Independence Requirements

The Final Rules direct the exchanges to adopt listing standards requiring that each member of a listed issuer’s compensation committee must be a member of the board of directors and must be “independent.” The term “independent” is not defined in Section 10C of the Exchange Act (“Section 10C”). Pursuant to the Final Rules, the exchanges are required to develop a definition of “independence” that will be applicable to compensation committee members, but the definition of independence does not have to be uniform among the different exchanges. Although the exchanges have flexibility to develop independence requirements appropriate

¹ See *Listing Standards for Compensation Committees*, Release Nos. 33-9330; 34-67220; File No. S7-13-11 (June 20, 2012), available at <http://www.sec.gov/rules/final/2012/33-9330.pdf>. For purposes of the Final Rules, a “national securities exchange” refers to an exchange registered as such under Section 6 of the Exchange Act and includes the New York Stock Exchange (“NYSE”) and The NASDAQ Stock Market (“Nasdaq”). For purposes of the Final Rules, a “national securities association” is an association of brokers and dealers registered as such under Section 15A of the Exchange Act. The Financial Industry Regulatory Authority (“FINRA”) is the only national securities association registered with the SEC. Because FINRA does not list equity securities, however, we refer only to the exchanges in this memorandum.

² The Dodd-Frank Act is available at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173>. Section 952 of the Dodd-Frank Act added Section 10C to the Exchange Act, and the text of Section 10C is contained in Section 952 of the Dodd-Frank Act. For purposes of the Final Rules, the SEC has interpreted the compensation committee and other requirements in Section 10C to apply only to issuers with listed *equity* securities (emphasis added).

³ For a discussion of the proposed rules, please see our firm memorandum, *SEC Proposes New Rules Regarding Compensation Committees and Compensation Advisors* (April 6, 2011), available at http://www.cahill.com/news/memoranda/100272/_res/id=sa_File1/CGR%20Memo%20-%20SEC%20Proposes%20New%20Rules%20Regarding%20Compensation%20Committees%20and%20Compensation%20Advisers.pdf.

for the issuers listed on each given exchange in developing the definition, the exchanges are required to consider certain “relevant factors,” including, but not limited to:⁴

- the source of a director’s compensation, including any consulting, advisory or other compensatory fee paid by the issuer to such director; and
- whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

III. Compensation Committee Advisers, Responsibilities and Funding

The Final Rules direct the exchanges to adopt listing standards requiring that each listed issuer’s compensation committee have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, legal counsel and other advisers (collectively, “compensation advisers”). Before a compensation committee can select a compensation adviser, however, it will be required to consider the following six independence factors (“Independence Factors”) identified by the SEC:

- the provision of other services to the issuer by the person that employs the compensation adviser;
- the amount of fees received from the issuer by the person that employs the compensation adviser, as a percentage of such person’s total revenue;
- the policies and procedures which have been adopted by the person employing the compensation adviser that are designed to prevent conflicts of interest;
- any business or personal relationship which the compensation adviser may have with a member of the compensation committee;
- any stock of the issuer owned by the compensation adviser;⁵ and
- any business or personal relationships between the executive officers of the issuer and the compensation adviser or the person employing the adviser.

The Final Rules do not require a compensation adviser to be independent, only that the compensation committee consider the Independence Factors before selecting a compensation adviser. Compensation committees may select any compensation adviser they prefer, including one that is not independent, so long as they do so after considering the Independence Factors.⁶ In addition, an instruction to the Final Rules provides that

⁴ The Final Rules require only that the exchanges *consider* these factors in developing independence standards for compensation committee members. This is in contrast to the language in Section 10A(m) of the Exchange Act, which expressly states that the presence of these factors *precludes* independence in the case of audit committee members.

⁵ The SEC notes in the release containing the Final Rules that the Final Rules do not expand the stock ownership factor to require consideration of stock owned by the person employing a compensation adviser. Rather, this factor only requires consideration of shares owned by the individuals providing services to the compensation committee and their immediate family members.

⁶ The listing standards do not override any duties imposed on directors by applicable state laws relating to the selection of compensation advisers.

a compensation committee need not consider the Independence Factors before consulting with or obtaining advice from in-house counsel.

Pursuant to the Final Rules, the exchanges must also adopt listing standards requiring that each listed issuer's compensation committee have direct responsibility for the appointment, compensation and oversight of the work of the compensation advisers that it retains. The Final Rules make clear that the compensation committee's authority to retain, and its responsibility for overseeing the work of, the compensation advisers should not, however, be construed to require the compensation committee to implement or act consistently with the advice or recommendations of the compensation adviser or to affect the compensation committee's ability or obligation to exercise its own judgment in the fulfillment of its duties. In addition, the Final Rules do not require compensation committees to retain or obtain advice only from independent advisers. Compensation committees may receive advice from non-independent counsel, such as in-house counsel, or from other non-independent compensation consultants or advisers, including those engaged by management.

The Final Rules also direct the exchanges to adopt listing standards requiring that each listed issuer must provide appropriate funding for payment of reasonable compensation, as determined by the compensation committee, to any compensation adviser retained by the compensation committee.

IV. Opportunity to Cure Defects

Pursuant to the Final Rules, the exchanges are also required to establish procedures for listed issuers to have a reasonable opportunity to cure any non-compliance with the compensation committee listing requirements that could result in the delisting of an issuer's securities. The Final Rules also permit the exchanges' rules to provide that if a member of a listed issuer's compensation committee ceases to be independent for reasons outside of the member's reasonable control, so long as notice is provided by the issuer to the applicable exchange, that person may remain a compensation committee member of the listed issuer until the earlier of the next annual shareholders' meeting or one year from the occurrence of the event that caused the member to no longer be independent.

V. Exemptions From the Listing Requirements

Pursuant to the Final Rules, the exchanges are required to exempt the following categories of companies from the listing requirements related to compensation committee member independence:

- Limited partnerships;⁷
- Companies in bankruptcy proceedings;⁸
- Open-end management investment companies registered under the Investment Company Act of 1940 ("Investment Company Act");⁹ and

⁷ Section 10C does not define the term "limited partnerships." For purposes of the Final Rules, however, a "limited partnership" refers to a form of business ownership and association consisting of one or more general partners who are fully liable for the debts and obligations of the partnership and one or more limited partners whose liability is limited to the amount invested.

⁸ This term is not defined in Section 10C or the SEC rules.

⁹ Under the Investment Company Act, an open-end management investment company is an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable

- Foreign private issuers that provide annual disclosures to shareholders of the reasons why the foreign private issuer does not have an independent compensation committee.¹⁰

The Final Rules also exempt controlled companies, security futures products, standardized options and smaller reporting companies from the listing requirements related to compensation committee member independence.¹¹ The Final Rules also permit the exchanges to exempt particular relationships and categories of issuers from the compensation committee member independence requirements, taking into account such factors as the size of an issuer and any other factors that the exchanges deem relevant and appropriate.

VI. Compensation Consultant Disclosure and Conflicts of Interest

The Final Rules amend Item 407(e)(3) of Regulation S-K (“Item 407”) to require issuers, other than registered investment companies,¹² to disclose, in any proxy or information statement relating to an annual meeting of shareholders (or a special meeting in lieu of an annual meeting) at which directors are to be elected, whether the work of any compensation consultant that has played any role in determining or recommending the amount or form of executive and director compensation (other than any role limited to consulting on broad-based plans or providing non-customized benchmark data) has raised a conflict of interest. If so, the issuer must also disclose the nature of the conflict and how the conflict is being addressed. The Final Rules include an instruction to new Item 407(e)(3)(iv) providing that in deciding whether there is a conflict of interest that may require disclosure under Item 407(e)(3)(iv), issuers should, at a minimum, consider the six Independence Factors. These new disclosure rules apply to all issuers subject to SEC proxy rules, including controlled companies, non-listed issuers and smaller reporting companies.¹³

security of which it is the issuer. The Final Rules define this term by referencing Section 5(a)(1) of the Investment Company Act.

¹⁰ Exchange Act Rule 3b-4 defines “foreign private issuer” as any foreign issuer other than a foreign government, except for an issuer that has more than 50% of its outstanding voting securities held of record by U.S. residents and any of the following: a majority of its officers and directors are citizens or residents of the United States, more than 50% of its assets are located in the United States, or its business is principally administered in the United States.

¹¹ Under the Final Rules, “controlled company” is defined as a listed company in which more than 50% of the voting power for the election of directors is held by an individual, a group or another company. This definition is consistent with the definition of the term used by the NYSE and Nasdaq. Section 10C(g) specifically exempts controlled companies from all the requirements of Section 10C. The Exchange Act defines “security futures product” as “a security future or any put, call, straddle, option, or privilege on any security future.” “Standardized options” are defined in Exchange Act Rule 9b-1(a)(4) as “option contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relate to option classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the [SEC] may, by order, designate.” “Smaller reporting issuers” refers to issuers with a public float of less than \$75 million.

¹² Registered investment companies will continue to be subject to the proxy disclosure requirements set forth in Item 22 of Schedule 14A, which do not include the compensation consultant disclosure requirement in Item 407(e)(3) of Regulation S-K; as such, registered investment companies will not be subject to the amendments to Item 407(e) required by the Final Rules.

¹³ Foreign private issuers that are not subject to SEC proxy rules will not be required to provide this disclosure.

VII. Compliance Timeline

Each national securities exchange and national securities association must submit its proposed rule changes to the listing standards to the SEC for approval no later than 90 days following publication of the Final Rules in the Federal Register. Further, each national securities exchange and national securities association must have final rules or rule amendments related to the listing standards that comply with the Final Rules approved by the SEC no later than one year after publication of the Final Rules in the Federal Register. Issuers must comply with the disclosure changes in Item 407 in any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of an annual meeting) at which directors will be elected occurring on or after January 1, 2013.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212-701-3110 or gwaldrip@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.