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

As Expected, Key Task of Setting Independence Standards Left to Exchanges

On June 20, 2012, the Securities and Exchange Commission issued final rules[1] directing the national securities exchanges to adopt listing standards related to the independence of compensation committees and their selection of advisers. SEC rulemaking on these topics was required by the Dodd Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[2] which prohibits national securities exchanges from listing any equity security of an issuer that is not in compliance with the exchange's compensation committee independence and adviser requirements. The final rules also specify the disclosures required for compensation consultant conflicts of interests.

The final rules largely mirror the proposed rules[3] issued by the SEC in March 2011 with a few key changes including:

- Broadening the definition of "compensation committees" that are subject to the independence requirements to include any committee or group of directors that oversees executive compensation.
- Expanding the factors to be considered in determining the independence of a compensation committee adviser to include *any business or personal relationship between the compensation adviser and the issuer's executive officers*.
- Modifying the compensation consultant conflicts of interest disclosures to apply to any compensation consultant who plays "any role" in "determining or recommending the amount or form of *executive and director* compensation," other than advice on broad based plans or non customized benchmarking data.
- Clarifying that disclosures relating to compensation consultants will apply to all issuers that are subject to the proxy rules (including controlled companies), but will be required only in proxy or information statements.

1 Listing Standards for Compensation Committees, Exchange Act Release Nos. 33-9330; 34-667220 (June 20, 2012) http://www.sec.gov/rules/final/2012/33-9330.pdf.

2 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (July 21, 2010).

3 For a discussion of the Proposed Rules, see our client publication "SEC's Proposed Rules on Compensation Committee Independence Largely *Follow Provisions of Dodd-Frank*" available at http://www.shearman.com/secs-proposed-rules-on-compensation-committee-independence-largely-follow-provisions-of-dodd-frank-04-04-2011/.

Timing and Effectiveness

Each exchange is obligated to provide proposed listing standards within 90 days after the publication of the final rules in the Federal Register. The listing standards must then be approved no later than one year following publication. While no action is currently required, upon release of proposed listing standards, issuers should review the composition of their compensation committees to ensure compliance with the applicable standards.

Compliance with the new disclosure requirements will be effective for any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected that occurs on or after January 1, 2013. Compensation committees should begin to review the independence of there advisers taking into account the factors set forth in the final rules and the enhanced disclosure requirements.

Definition of “Compensation Committee”

The final rules do not require a listed issuer to maintain a compensation or similar committee. References to “compensation committee” in the final rules generally refer to any board committee that oversees executive compensation, whether or not the committee also performs other functions (e.g., the corporate governance and nominating committee) or is formally designated as a compensation committee. The listing requirements also generally apply to members of the board of directors who, in the absence of a designated board committee, oversee executive compensation matters; however, the listing requirements relating to the compensation committee’s authority to retain compensation advisers and the required funding for payments to such advisers are not applicable to board members acting outside of a designated committee.

Compensation Committee Independence Requirements

For the most part, the final rules reiterate (with limited technical refinement) both the proposed rules and the requirements of the Dodd-Frank Act. Final Exchange Act Rule 10C directs the national securities exchanges to require that each member of an issuer’s compensation committee be a member of the issuer’s board of directors who is “independent” under the applicable exchange’s independence standards. The rules mirror the Dodd-Frank Act’s mandate that each exchange develop independence requirements after considering certain factors, including the source of compensation from the issuer provided to a given director, the director’s affiliation with the issuer, its subsidiaries or affiliates, as well as any other factors the exchange deems appropriate.

The final rules do not specify additional factors to be considered, establish independence standards, provide any safe harbors or exceptions, mandate a specified look-back period or exempt any particular relationship between compensation committee members and issuers. These topics are left to the exchanges. In its adopting release, the SEC noted that while it expects the exchanges to consider whether their audit committee independence standards should also apply to compensation committee members, there is no requirement to adopt those standards. The SEC further notes that exchanges should consider a variety of factors, including affiliate relationships, share ownership and personal or business relationships between a member of the compensation committee and the executive officers in determining independence standards.

Exempt Issuers. The SEC has exempted the following issuers from the compensation committee independence requirements: (1) controlled companies, [4](2) foreign private issuers that provide annual disclosures of the reasons why they do not have an independent compensation committee, (3) limited partnerships, (4) companies in bankruptcy proceedings and (5) open end management investment companies registered under the Investment Company Act. The exchanges also have the authority to exempt other issuers, such as "emerging growth companies" under the JOBS Act.

Compensation Advisers

Authority to Retain Compensation Advisers, Responsibilities, and Funding. The Dodd-Frank Act requires that compensation committees have the authority to retain or obtain the advice of compensation advisers. This requirement includes not only compensation consultants, but also independent legal counsel and other advisers. Compensation committees must be afforded the sole discretion to appoint, compensate and oversee the work of its compensation advisers. An issuer must provide its compensation committee with "appropriate funding" for the payment of "reasonable compensation" to compensation advisers. The requirements would be implemented though listing standards adopted by the exchanges.

The final rules largely mirror the Act and the proposed rules in this regard. The SEC did clarify that the compensation committee is not required to be directly responsible for the appointment, compensation or oversight of advisers that are not expressly retained by the committee, such as compensation consultants or legal counsel retained by management and in-house counsel.

Independence Factors. Under the final rules compensation committees must consider certain independence factors before selecting a compensation adviser. The factors mirror those of the Dodd-Frank Act with the addition of a sixth factor italicized below:

- whether the entity employing the compensation adviser provides other services to the issuer;
- the amount of fees received from the issuer by the entity employing the compensation adviser as a percentage of its total revenues;
- the policies and procedures of the entity employing the compensation adviser designed to prevent conflicts of interest;
- any business or personal relationship between the compensation adviser and a member of the compensation committee;
- whether the compensation adviser owns any stock in the issuer;[5] and
- *any business or personal relationship between the compensation adviser or the employing entity and the issuer's executive officers.*

[4] For purposes of the final rules, a "controlled company" means any listed company where more than 50% of the voting power for the election of directors is held by an individual, a group or another company.

[5] The SEC clarified that the stock ownership factor only applies to the individual adviser and not the entity employing the adviser.

The independence assessment must be conducted on any compensation consultant, legal counsel or other adviser that provides advice to the committee, whether or not the adviser was retained by the committee. In-house legal counsel, however, are not subject to the independence assessment.

No Adviser Independence Requirement. The final rules do not require that a compensation adviser actually be independent, but only that the compensation committee consider the forgoing factors when deciding to hire or seek advice from a given adviser. The SEC clarified that the six factors should be considered in their totality, and no one factor should be viewed as a determinative of independence. Accordingly, the final rules do not impose any materiality or bright line thresholds on the factors. In addition, the rules do not require compensation committees to retain a compensation consultant or legal or other adviser, or preclude such adviser from providing other services to the issuer.

The SEC has exempted controlled companies and smaller reporting companies from the compensation adviser independence rules. In addition, the listing of certain securities futures products and standardized options are not subject to the rules. Notably, however, the compensation adviser independence rules are applicable to foreign private issuers unless the exchanges elect to exempt them.

Opportunity to Cure Defects

The final rules require the exchanges to establish definitive procedures and compliance periods, if they do not already have adequate procedures in place, to be followed prior to delisting an issuer's securities. The listing standards will create a safe harbor for any member of a compensation committee who ceases to be independent for reasons outside the member's reasonable control and will allow the member to remain on the compensation committee until the earlier of the issuer's next annual meeting or one year from the event that caused the member to no longer be independent, as contemplated in the Dodd-Frank Act. No changes were made from the proposed rules in this regard.

Compensation Consultant Disclosure and Conflicts of Interest

The Dodd-Frank Act dictates when an issuer must disclose whether the compensation committee has "retained or obtained" the advice of a compensation consultant, whether the work of the compensation consultant has raised any conflicts of interest and, if so, the nature of the conflict and how the conflict is being addressed. Currently, Item 407 of Regulation S K requires registrants to disclose "any role of the compensation consultants in determining or recommending the amount or form of executive and director compensation."

Given the similarities between the disclosures required under Item 407 and the Dodd-Frank Act, the proposed rules would have combined them into a single disclosure requirement by expanding the disclosure triggers and eliminating the exclusions for disclosure when the consultant provides advice on broad based plans or provides only non customized benchmark data.

The final rules eliminate the integration. The existing compensation consultant disclosures under Item 407 remain unchanged. A new subsection under Item 407 requires the Dodd-Frank conflicts disclosure with respect to any consultant identified and disclosed under the existing Item 407 rules, whether the consultant is retained by management or the committee. An instruction to Item 407 provides that issuers should, at a minimum, consider the six independence factors in determining whether a conflict of interest exists. The final rules retain (1) the disclosure obligations with respect to consultants who advise on director compensation and (2) the exclusions for disclosure when the consultant provides advice on broad based plans or provides only non customized benchmarking data. There is no obligation to disclose the committee's process for selecting advisers.

These disclosure rules apply to all issuers that are subject to the proxy rules, including controlled companies and smaller reporting companies. Consequently, foreign private issuers are not subject to the proxy rules would not be subject to these disclosure requirements.

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