

SEC Adopts Rules Requiring Listing Standards for Compensation Committees and Compensation Advisers

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On June 20, 2012 the Securities and Exchange Commission adopted rules under the Securities Exchange Act of 1934 (Exchange Act), that direct the national securities exchanges to adopt listing standards for public company boards of directors, compensation committees, and compensation advisers. These rules implement Section 10C of the Exchange Act enacted as part of 2010's Dodd-Frank legislation. The SEC has amended its proxy disclosure rules correspondingly to require new disclosures from companies about their use of compensation consultants and conflicts of interest.

LISTING STANDARDS

The new rules regarding listing standards will take effect 30 days after publication in the Federal Register. The exchanges will then have 90 days after effectiveness to propose listing standards that comply with the new rules and one year after effectiveness to finalize the rules and receive approval from the SEC. Depending on how fast the SEC and the exchanges work the new listing standards could be in effect as soon as the 2013 proxy season. Once the new listing standards are in effect, issuers listed on national securities exchanges will have to comply with the specific standards established by the exchange on which they are listed.

This alert summarizes the SEC's directives to the exchanges, but the particular compliance obligations of public companies will depend on how the exchanges implement the new rules.

Independence Requirement

Under new Exchange Act Rule 10C-1(b)(1), the national securities exchanges must adopt listing standards requiring each member of an issuer's compensation committee to be an independent member of the issuer's board of directors. In determining independence requirements, the exchanges must consider factors including, but not limited to,

- the source of compensation of a member of the board (including consulting, advisory or other compensatory fees) and
- whether a member of the board is an affiliate of the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

In the absence of a compensation committee, these independence requirements will also apply to members of the board who oversee compensation on behalf of the board of directors.

Most exchanges already require directors who determine executive compensation to be independent under existing listing standards. This new rule is intended to allow the exchanges to develop their own standards of independence for compensation committee members as long as the above factors are considered. Interestingly, the SEC seems willing to allow the exchanges to adopt standards that do not prohibit all affiliates from serving on a compensation committee.

After considering the specified factors, the exchanges may determine that certain affiliates should be permitted to serve on a compensation committee. The SEC advises that exchanges should consider ties between the issuer and a director that may impair the director's judgment as a member of the compensation committee.

The new rules grant the compensation committee the authority, similar to audit committees, to retain compensation consultants, independent legal counsel or other compensation advisers and require that the issuer provide for appropriate funding to compensate such advisers. Exchange Act Rule 10C-1(b)(2) provides that compensation committees have sole discretion as to whether or not to retain or obtain compensation advisers and that the compensation committee is directly responsible for the appointment, compensation and oversight of any such adviser so retained. This authority to retain advisers and the responsibility for their oversight also applies to members of the board of directors who oversee executive compensation matters in the absence of a compensation committee.

Under the new rules, compensation committees are not required to retain advisers, but are given the have the authority to do so. Compensation committees are also not required to obtain advice from independent advisers; compensation committees may receive advice from in-house legal counsel, or from advisers retained by management. Should a compensation committee decide to retain an adviser, independent or not, Exchange Act Rule 10C-1(b)(3) provides that issuers must provide for the payment of reasonable compensation to any such compensation consultant or adviser retained by the compensation committee.

In addition, Exchange Act Rule 10C-1(b)(2)(iii) specifies that the compensation committees are not required to act consistently with or implement the advice or recommendations of any adviser it retains.

Adviser Independence

The listing standards of exchanges must also require compensation committees, or board members who oversee executive compensation matters in absence of a compensation committee, to consider certain independence factors before engaging any consultant or advisers. The exchanges may set their own list of considerations, but such considerations must at least include the following:

- Whether the compensation consulting company employing the compensation adviser is providing any other services to the issuer;
- The amount of fees received by the compensation consulting company who employs the compensation adviser, as a percentage of that company's total revenue;
- What policies and procedures have been adopted by the compensation consulting company employing the adviser to prevent conflicts of interest;
- Whether the compensation adviser has any business or personal relationship with a member of the compensation committee;
- The stock ownership of the issuer by the compensation adviser; and
- Whether the compensation adviser, or the compensation consulting company who employs the compensation adviser, has any business or personal relationship with an executive officer of the issuer.

These factors, and any other factors imposed by the exchanges, should be considered in their totality and no one factor should be considered a determinative factor of independence. If, after considering the factors, the compensation committee determines the compensation adviser is not independent, the compensation committee may still retain such adviser so long as the committee has considered all the required factors. The Commission also clarifies that the compensation committee would not have to consider these factors before receiving advice from the issuer's in-house counsel.

Exemptions

The listing standards for compensation committees and compensation advisers do not apply to any controlled company (typically majority owned) or "smaller reporting company" (defined by the SEC as an issuer having a public float of less than \$75 million). The exchanges may also exempt other categories of issuers with approval by the SEC.

PROXY DISCLOSURE

The proxy rules already require disclosure regarding any role compensation consultants play in determining the compensation of executive officers and directors (including the name of such consultant and any fees paid). The SEC has now amended the proxy rules to

require additional disclosure with respect any compensation consultant whose work has raised a conflict of interest pursuant to the factors listed in Exchange Act Rule 10C-1(b)(iv) (discussed above). Pursuant to new Item 407(e)(3)(iv) of Regulation S-K, issuers will be required to disclose the nature of any conflict of interest and how the conflict is being addressed. This disclosure is not required where there is only a potential conflict of interest or the appearance of a conflict of interest.

Issuers must comply with this disclosure requirement in any proxy statement for any annual or special meeting of shareholders at which directors will be elected occurring on or after January 1, 2013.

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