

# Client Alert

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## SEC Adopts Rule Requiring Listing Standards for Compensation Committees and Compensation Advisers; Proxy Disclosure Requirements Updated

The Securities and Exchange Commission (the “SEC”) recently adopted a new rule requiring that national securities exchanges establish listing standards for public company boards of directors and compensation advisers. The listing standards relate to the following topics:

- the independence of compensation committee members;
- the compensation committee’s authority to retain compensation advisers and the committee’s oversight of compensation advisers’ appointment, pay, and work; and
- the compensation committee’s consideration of compensation advisers’ independence.

The SEC has also amended the proxy disclosure rules included in Regulation S-K to require new disclosures from issuers related to their compensation consultants and conflicts of interest.

The new rule, as well as the amendments to Regulation S-K, will take effect on July 27, 2012. Each exchange will have 90 days thereafter to propose listing standards that comply with the new rule and must adopt final listing standards no later than June 27, 2013. Issuers subject to the SEC’s proxy rules will be required to comply with the new proxy statement disclosure requirements for the 2013 proxy season. The SEC release is available at: [www.sec.gov/rules/final/2012/33-9330.pdf](http://www.sec.gov/rules/final/2012/33-9330.pdf).

### Background

Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) added Section 10C of the Securities Exchange Act of 1934 (the “Exchange Act”). Section 10C, in part, requires the SEC to adopt rules directing national securities exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C’s compensation committee and compensation adviser requirements. Pursuant to Section 10C, the SEC has adopted Rule 10C-1.

In adding Section 10C(c)(2) of the Exchange Act, the Dodd-Frank Act also requires that proxy materials disclose

whether the compensation committee of an issuer’s board of directors retained or obtained advice from a compensation consultant. If the committee has received such advice, the proxy materials must disclose whether the work created conflicts of interest and how those conflicts are being addressed. The SEC has adopted disclosure changes in Item 407 of Regulation S-K to implement the requirements of Section 10C(c)(2) of the Exchange Act. As amended, Item 407 will encompass the requirements of Section 10C(c)(2) but will also mandate a broader disclosure of conflicts involving any compensation consultant who played a role in determining or recommending executive and director compensation.

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## Independence of Compensation Committee Members

Rule 10C-1 directs the exchanges to establish listing standards that require each member of a listed issuer's compensation committee to be independent and a member of the board of directors. Where a listed issuer does not have a formal compensation committee, this requirement will apply to members of the issuer's board who perform functions typically performed by a compensation committee, such as oversight of executive compensation.

In the adopting release, the SEC has not required that the exchanges establish a uniform definition of independence specific to compensation committee members. Instead, each exchange is instructed to develop independence requirements that are appropriate for its issuers, subject to review and final approval by the SEC. In creating a definition of independence for compensation committee members, the SEC requires each exchange to consider the following factors:

- a director's source of compensation, including consulting, advisory, or compensatory fees paid by the issuer; and
- whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

The SEC declined to define the term "affiliate" in the adopting release. Although each exchange is required to consider affiliate relationships in establishing a definition of compensation committee independence per the factors described above, listing standards need not prohibit an affiliate from serving on a compensation committee. Instead, an exchange may decide that certain affiliated directors should be able to serve on compensation committees.

The New York Stock Exchange ("NYSE") and the NASDAQ Stock Market ("NASDAQ") already require that directors in specific roles — such as directors serving on an issuer's governance, compensation, or audit committee — be independent based on the exchange's general independence standards. The NYSE, NASDAQ, and other exchanges generally prescribe certain bright-line independence tests (including restrictions on compensation, employment, and familial or other relationships with the listed issuer or the executive officers of the listed issuer that could interfere with the exercise of

independent judgment) that directors must meet in order to be considered independent. In addition, under both NYSE and NASDAQ rules, directors may be disqualified based on their or their family members' relationships with a listed issuer's auditor, affiliation with entities that have material business relationships with the listed issuer, or employment at a company whose compensation committee includes any of the listed issuer's executive officers.

In light of the independence standards currently employed by the NYSE, NASDAQ, and other exchanges, the new compensation committee independence requirements that the exchanges must adopt pursuant to Rule 10C-1 will likely provide for only moderate adjustments or supplements to the current independence standards (i.e. additional definition or interpretations of an "affiliate").

## Compensation Committee Authority, Oversight, and Funding

Rule 10C-1 instructs the exchanges to adopt listing standards related to the authority and funding for compensation advisers, described below.

- A listed issuer's compensation committee must be able to retain or obtain the advice of a compensation adviser at the committee's sole discretion. Compensation committees are not limited to receiving advice from independent advisers and can receive advice from non-independent compensation advisers, legal counsel, and other consultants. The rule does not specify whether utilizing the advice of non-independent advisers will require additional disclosure. Additionally, the SEC has not defined the term "independent legal counsel," but in-house counsel and outside counsel retained by management are cited as examples of non-independent counsel.
- A listed issuer's compensation committee must be directly responsible for the appointment, compensation, and oversight of compensation advisers retained by the committee. Where a listed issuer does not have a formal compensation committee, this requirement will apply to members of the issuer's board who perform functions typically performed by a compensation committee, such as oversight of executive compensation.
- A listed issuer must provide funding for payment of reasonable compensation, determined by the

compensation committee, for advisers retained by the committee.

## Compensation Adviser Selection

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Rule 10C-1 directs the exchanges to adopt listing standards mandating that listed issuer compensation committees consider specific factors relating to independence before selecting a compensation adviser. Where a listed issuer does not have a formal compensation committee, this requirement will apply to members of the issuer's board who perform functions typically performed by a compensation committee, such as oversight of executive compensation.

Listed issuer compensation committees must consider the following six independence factors, in their totality, in addition to supplementary factors imposed by each exchange:

- whether the compensation consulting company employing the compensation adviser is providing any other services to the company;
- how much the compensation consulting company employing the compensation adviser has received in fees from the issuer, as a percentage of the compensation consulting company's total revenue;
- what policies and procedures to prevent conflicts of interest have been adopted by the compensation consulting company employing the compensation adviser;
- whether the compensation adviser has any business or personal relationships with a member of the compensation committee;
- whether the compensation adviser owns any stock of the company, including shares owned by the immediate family members of the adviser; and
- whether the compensation adviser or the person employing the adviser has any business or personal relationships with an executive officer of the issuer.

The rule only requires that a listed issuer's compensation committee consider the independence factors prior to selecting an adviser and does not require that a compensation adviser necessarily be independent. Further, the independence factors need not be considered

where the adviser at issue is in-house legal counsel, as such advisers are employees and are not held out to be independent. While the new SEC rule does not require issuers to disclose, in proxy statements, their compensation committee's process for selecting compensation advisers based on the listing standard independence factors, an issuer's selection process, including an analysis of its factors, will likely be disclosed in the description of the compensation adviser's role in setting compensation (including any conflicts of interest). See "Proxy Compensation Consultant Disclosure and Conflicts of Interest" below.

## Exemptions and Cure

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The SEC has exempted controlled companies and smaller reporting companies from all of the requirements of Rule 10C-1. Additionally, Rule 10C-1 authorizes the exchanges to exempt particular relationships from the compensation committee member independence requirements and exempt any category of issuers from the requirements set forth in Section 10C.

Rule 10C-1 will exempt the following issuers from listing requirements that relate to compensation committee independence:

- limited partnerships;
- companies in bankruptcy proceedings;
- open-ended 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 rule directs the exchanges to prohibit the listing of any equity security of an issuer, other than an issuer that falls into one of the four specified categories listed above, that is not in compliance with the compensation committee member independence requirements.

Rule 10C-1 mandates that the exchanges provide procedures for listed issuers to have a reasonable opportunity to cure violations of the compensation committee listing requirements that could result in delisting of an issuer's securities. While the rule does not specify cure procedures, the exchanges are authorized to allow a

member of a compensation committee — who ceases to be independent for reasons outside the member's reasonable control — to 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.

## Proxy Compensation Consultant Disclosure and Conflicts of Interest

Currently, Item 407 of Regulation S-K requires Exchange Act registrants that are subject to the proxy rules to provide disclosures regarding their compensation committees and the use of compensation consultants. Specifically, current Item 407 requires disclosure of any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. As a result, registrants must disclose, for each consultant, the nature and scope of their assignments, who engaged them, and, for any consultant retained by the compensation committee (or, in the absence of a committee consultant, by management), the aggregate fees paid to the consultant for executive compensation consulting and for other types of consulting where the fees for the other services exceed \$120,000. Registered investment companies are not required to make such disclosures.

To supplement these existing requirements, under the Item 407(e)(3)(iv) amendment to Regulation S-K, issuers subject to the proxy rules will be required to disclose, with respect to any compensation consultant having played a role in determining or recommending the amount or form of executive and director compensation, whether the work of any compensation consultant has raised any conflict of interest. In addition to disclosing the nature of these conflicts, the issuer must disclose how the conflicts are being addressed. In deciding whether there is a conflict of interest that may need to be disclosed, the amendments to Regulation S-K will instruct issuers, at a minimum, to consider the six factors used in the selection of a compensation adviser. Best practices for determining whether a conflict of interest exists and the appropriate level of disclosure (e.g., where there is a determination of no conflict) will likely develop as further interpretations emerge from the SEC on the Item 407(e)(3)(iv) amendment. Compliance with Item 407(e)(3)(iv) will be required in any proxy or information statement for an annual meeting of shareholders — or a special meeting in

lieu of the annual meeting — occurring on or after January 1, 2013, where directors will be elected.

## What Should I Do Now?

Boards of directors of Exchange Act registrants will be required to comply with the proxy statement disclosure requirements in the amendments to Regulation S-K for the 2013 proxy season. In preparation for these changes, we advise that issuers begin to obtain conflicts information from compensation consultants.

Many compensation consultants implemented practices that conform to Regulation S-K Item 407 when it was originally adopted. Issuers should contact the compensation consultants used by their compensation committee to determine what processes are currently in place to assess the independence factors required by the amendments to Regulation S-K. Based on this assessment, issuers can determine whether additional information is needed from compensation consultants in order to perform the conflicts of interest assessment required under the amendment.

New Rule 10C-1 will take effect on July 27, 2012. Each exchange will have 90 days thereafter to propose listing standards that comply with the new rule and must adopt final listing standards no later than June 27, 2013. In implementing new exchange listing standards, we suggest that issuers prepare to take the following actions:

- Amend compensation committee charters. Issuers should review and revise their compensation committee charters, as needed, to ensure that charters reflect the new listing standards. For example, amendments may be needed if an issuer's compensation committee charter does not currently confirm its compensation committee's authority to retain or obtain the advice of a compensation adviser and directly oversee the appointment, compensation, and oversight of compensation advisers it retains.
- Update director and officer questionnaires. By the June 2013 deadline, the exchanges will each adopt a definition of independence for compensation committee members. At that time, each issuer will need to update its director questionnaires in order to collect information required to assess compensation committee member independence under the definition adopted by its exchange.

Please contact your Chapman and Cutler LLP attorney to discuss compliance with new Rule 10C-1 and amendments to Regulation S-K. For information on recent Dodd-Frank developments and other financial updates, please see our publications website at <http://www.chapman.com/publications>.

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