

Management Alert



SEC Adopts Final Rules on Listing Standards and Disclosure Requirements for Compensation Committees and Compensation Consultants

On June 20, 2012, the U.S. Securities and Exchange Commission (the “Commission”) adopted final rules to implement requirements under Section 10C of the Securities and Exchange Act of 1934 (the “Exchange Act”), which was established by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).

The new rules (1) require the national securities exchanges to adopt listing standards regarding the composition and independence of listed issuers’ compensation committees, as well as the appointment, independence, compensation and oversight of listed issuers’ compensation advisers, and (2) require all issuers subject to the Commission’s proxy rules to disclose conflicts of interest relating to their use of such compensation consultants.

Procedurally, the exchanges must propose listing standards and requirements per these final rules. Once the Commission approves the exchanges’ rules and the exchanges implement them, issuers will have to comply with the exchanges’ standards and requirements in order for the issuers’ shares to continue trading on applicable exchanges. The exchanges must provide appropriate procedures for listed issuers to have a reasonable opportunity to cure any compliance defects prior to being delisted by an applicable exchange for failure to comply with the standards and requirements.

Compensation Committee Independence Requirements

The final rules require each of the members of the compensation committee (or another committee charged with the oversight of executive compensation) of an issuer listed on a national securities exchange to be a member of the listed issuer’s board of directors and to be “independent.” The director independence requirements will also apply to members of the board of directors who, in the absence of a board committee, oversee executive compensation matters on behalf of the board. Under the final rules, the exchanges are required to develop definitions of “independence” after taking into consideration relevant factors including, without limitation:

- The sources of compensation of a director of a listed issuer, including any consulting, advisory or other compensatory fee paid by the listed issuer to such director; and
- Whether the director is affiliated with the listed issuer or a subsidiary or affiliate of a subsidiary of the listed issuer.

Under the final rules, the exchanges have broad discretion in establishing independence standards and definitions. That is, the final rules do not prescribe mandatory independence criteria. Rather, the exchanges need only to consider the foregoing factors and any other relevant factors they deem appropriate in establishing such standards and definitions, and they will have discretion to permit certain categories of persons to serve on compensation committees (e.g., directors affiliated with significant shareholders such as private equity funds and venture capital firms). In this regard, we note that the final rules are more flexible than the audit committee independence requirements adopted under the Sarbanes-Oxley Act of 2002, which prescribe minimum independence criteria for the members of listed issuers’ audit committees.

In addition, the exchanges' rules may provide that if a compensation committee member ceases to be independent for reasons outside of that member's reasonable control, the member, with notice by the listed issuer to the applicable exchange, may remain a member of the listed issuer's compensation committee until the earlier to occur of the listed issuer's next annual meeting and one year from the occurrence of the event that caused such member to no longer be independent.

Compensation Consultants and Advisers

Retention of Compensation Advisers; Independence Considerations

Under the final rules, listed issuers' compensation committees will be permitted, in their sole discretion, to retain or obtain the advice of compensation advisers, including compensation consultants, independent legal counsel and/or other advisers ("Compensation Advisers"). Compensation committees (which for this purpose includes those members of a listed issuer's board of directors who oversee executive compensation matters on behalf of the board in the absence of a board committee) will be directly responsible for the appointment, compensation and oversight of the work of any such Compensation Advisers (though they would not be required to follow such advisers' recommendations). Listed issuers will be required to provide appropriate funding to cover the payment of reasonable compensation, as determined by the compensation committee, to any such Compensation Advisers retained by the compensation committee.

The final rules do not require listed issuers' compensation committees to engage Compensation Advisers, nor do they require that any Compensation Advisers engaged by the compensation committees be independent. However, prior to engaging any Compensation Advisers, listed issuers' compensation committees will be required to consider the following factors that may affect the independence of such Compensation Advisers, as well as any other relevant factors identified by the exchange:

- The provision of other services to the listed issuer by the employer of the Compensation Adviser;
- The amount of fees received from the listed issuer by the employer of the Compensation Adviser, as a percentage of such employer's total revenue;
- The policies and procedures of the employer of the Compensation Adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the Compensation Adviser with a member of the compensation committee;
- Any stock of the applicable listed issuer owned by the Compensation Adviser; and
- Any business or personal relationships between the executive officers of the listed issuer and the Compensation Adviser or the person employing the adviser.

The final rules do not include any materiality, numerical or other thresholds regarding the foregoing factors that would narrow the circumstances in which a compensation committee is required to consider the six independence factors. However, the final rules provide that a compensation committee need not consider the six independence factors before consulting with or obtaining advice from in-house counsel. The exchanges will have discretion to exempt certain categories of listed issuers from the foregoing requirement.

Disclosure Matters Relating to Compensation Consultants

The final rules add a new Item 407(e)(3)(iv) of Regulation S-K requiring all issuers subject to the Commission's proxy rules to disclose in any proxy or information statement relating to an annual meeting of shareholders at which directors are to be elected (or a special meeting in lieu thereof) whether the work of the compensation consultant required to be identified under existing Item 407(e)(3)(iii) has raised any conflict of interest, and if so, the nature of the conflict and how it is being addressed.

Revised Item 407(e) of Regulation S-K includes instructions identifying the six factors listed above under the caption "*Retention of Compensation Advisers; Independence Considerations*" as among the factors that issuers should consider in determining whether a conflict of interest exists.

In a departure from the proposed rules, the Commission determined that existing disclosure requirements under Item 407(e)(3)(iii) of Regulation S-K implement the disclosures required under Section 10C(c)(2)(A) of the Exchange Act, which requires an issuer to disclose whether its compensation committee retained or obtained the advice of a compensation consultant.

Existing Item 407(e)(3)(iii) of Regulation S-K requires disclosure, with certain exceptions, of *any* role compensation consultants played in determining or recommending the amount or form of executive and director compensation.

Exemptions

The final rules relating to listing standards for compensation committee independence and the retention and independence of compensation advisers would generally apply to all issuers with listed equity securities, except as follows:

- The following four categories of issuers will not be subject to the compensation committee independence requirements described above: (1) limited partnerships; (2) companies in bankruptcy proceedings; (3) open-end management investment companies under Section 5(a)(1) of the Investment Company Act of 1940; and (4) foreign private issuers that disclose in their respective annual reports the reasons that they do not have an independent compensation committee.
- The following categories of issuers would be exempt from all of the new rules relating to compensation committee independence and the retention and independence of compensation advisers: (1) clearing agency issuers of security futures products and standardized options, (2) controlled companies¹ and (3) smaller reporting companies, as defined in Exchange Act Rule 12b-2.

The exchanges are permitted to exempt other relationships from the compensation committee independence requirements after considering issuer size and other relevant factors, and to exempt other categories of issuers from the requirements of Section 10C of the Exchange Act after taking into account the potential impact of such requirements on smaller reporting issuers.

In addition, as noted above, the new conflict of interest disclosures which will be required under the amendments to Item 407(e) of Regulation S-K will apply to all issuers that are subject to the Commission's proxy rules (including controlled companies, non-listed issuers and smaller reporting companies).

Timing

Under these final rules, the exchanges will have to:

- Submit proposed rules and listing standards to the Commission for approval no later than September 25, 2012; and
- Adopt final, Commission-approved rules no later than June 27, 2013.

The new conflict of interest disclosures required under the amendments to Item 407(e) of Regulation S-K will be required in any proxy or information statements for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013.

The final rule release is available [here](#).

For more information or if you have specific questions regarding the final rules, please contact the Seyfarth attorney with whom you work or any Securities or Executive Compensation attorney on our [website](#).

¹ A "controlled company" is a 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.

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