

## Resources

### SEC Adopts Compensation Committee Rules

Stock exchanges and NASDAQ must adopt listing standards to implement changes.

**June 29, 2012**

The Securities and Exchange Commission (SEC) has adopted a new rule and amendments to its proxy disclosure rules regarding compensation committee independence and compensation adviser conflicts of interest to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), which added Section 10C to the Securities Exchange Act of 1934. Section 10C requires the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C's independent compensation committee and compensation adviser requirements.

The new rule and rule amendments will take effect 30 days after publication in the Federal Register. The securities exchanges must propose listing standards that comply with the final rules to the SEC within 90 days of the date of publication in the Federal Register. Those proposed listing standards will be open to public comment and then must be approved by the SEC no later than one year after such date. Accordingly, it is unclear whether the requirements of the final rules (other than the amendment to Item 407 discussed below) will be effective for the 2013 proxy season; although it's likely that the SEC will act to make it so.

#### Rule 10C-1

In accordance with the Dodd-Frank mandate, new Rule 10C-1 directs the national securities exchanges and national securities associations to establish listing standards that, among other things, require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent," as defined in the listing standards of the exchanges or associations as adopted in accordance with the final rule. The new rule requires the listing standards to address:

- The independence of the members on a compensation committee or any committee performing compensation functions or, if there is no such committee, the members of the board performing the compensation review function;
- The committee's authority to retain compensation advisers;
- The committee's consideration of the independence of any compensation advisers; and
- The committee's responsibility for the appointment, compensation, and oversight of the work of any compensation adviser.

The SEC's rules, however, do not require that a listed issuer establish a compensation committee, nor does Section 10C. Current listing standards, such as those used by the New York Stock Exchange (NYSE), generally require listed issuers either to have a compensation committee or to have independent directors determine, recommend or oversee specified executive compensation matters. On the other hand, the NASDAQ Stock Market does not mandate that a listed issuer have a compensation committee, but requires that executive compensation be determined or recommended to the board for determination either by a compensation committee composed solely of independent directors or by a majority of the board's independent directors in a vote in which only independent directors participate. The new listing standards apply to these alternative means of determining compensation other than the requirement to permit retention of compensation advisers and provide for funding their compensation.

**Independence.** The term "independent" is not defined in Section 10C. Instead, Section 10C(a)(3) provides that "independence" is to be defined by the exchanges after taking into consideration "relevant factors." According to the SEC, in determining independence requirements for members of compensation committees, the national securities exchanges and national securities associations must consider relevant factors including, but not limited to (A) the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors; and (B) whether a member of the board of directors of an

issuer is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The final rule does not specify any additional factors that the exchanges must consider in determining independence requirements for compensation committee members, nor does the final rule prescribe any standards or relationships that will automatically preclude a finding of independence. In response to concerns noted by some commentators that significant shareholders may have other relationships with listed companies that would result in such shareholders' interests not being aligned with those of other shareholders, the SEC emphasized that it is important for exchanges to consider other ties between a listed issuer and a director, in addition to share ownership, that might impair the director's judgment as a member of the compensation committee. For example, according to the SEC, the exchanges might conclude that personal or business relationships between members of the compensation committee and the listed issuer's executive officers should be addressed in the definition of independence.

**Compensation Advisers.** Section 10C(c)(1) of the Exchange Act provides that the compensation committee of a listed issuer may, in its sole discretion, retain or obtain the advice of a "compensation consultant," and Section 10C(d) extends this authority to "independent legal counsel and other advisers." The SEC did not construe the requirements related to independent legal counsel and other advisers as set forth in Section 10C(d) as requiring a compensation committee to retain independent legal counsel or as precluding a compensation committee from retaining non-independent legal counsel or obtaining advice from in-house counsel or outside counsel retained by the issuer or management.

The statute does not require a compensation adviser to be independent, only that the compensation committee of a listed issuer consider certain enumerated independence factors before selecting a compensation adviser. In this regard, the compensation committee of a listed issuer may select a compensation consultant, legal counsel or other adviser to the compensation committee only after taking into consideration the following factors, as well as any other factors identified by the relevant exchange or securities association in its listing standards:

1. The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;
2. The amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;
3. The policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
4. Any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;
5. Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser; and
6. Any business or personal relationship of the compensation consultant, legal counsel, other adviser or the person employing the adviser with an executive officer of the issuer.

Moreover, the final rule does not include any materiality, numerical or other thresholds that would narrow the circumstances in which a compensation committee is required to consider the independence factors specified in the rule. The SEC was concerned that adding materiality or other bright-line thresholds may not be competitively neutral. The absence of any such thresholds means that all facts and circumstances relevant to the six factors will be presented to the compensation committee for its consideration of the independence of a compensation adviser, and not just those factors that meet a prescribed threshold. Whether the adviser is independent or not, the listing requirements need not force the committee to follow the adviser's advice.

Finally, the final rule does not require listed issuers to describe the compensation committee's process for selecting compensation advisers pursuant to the new listing standards. According to the SEC, it was sensitive to the concerns of commentators that adding such disclosure would increase the length of proxy statement disclosures on executive compensation without necessarily providing additional material information to investors.

**Opportunity to Cure Defects.** As adopted, Rule 10C-1(a)(3) requires the exchanges to provide appropriate procedures for listed issuers to have a reasonable opportunity to cure any noncompliance with the compensation committee listing requirements that could result in the delisting of an issuer's securities. In this regard, the exchanges' rules may also provide that if a member of a listed issuer's compensation committee ceases to be independent for reasons outside the member's

reasonable control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member of the listed issuer until the earlier of the next annual shareholders' meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent. The listing standards also provide exceptions for controlled companies, limited partnerships, companies in bankruptcy, open-end investment companies and foreign private issuers.

## Regulation S-K Item 407

The SEC modified Item 407(e) of Regulation S-K to include a new disclosure requirement relating to compensation consultant or adviser conflicts of interest. With regard to any compensation consultant that had any role in determining or recommending the amount or form of executive and director compensation whose work raised any conflict of interest, new Item 407(e)(3)(iv) will require issuers to disclose the nature of the conflict and how the conflict is being addressed. Potential or apparent conflicts are not intended to require disclosure under the new rule. In deciding whether a conflict existed, issuers must consider at least the six factors noted above from the listing standard. Also, the rule clarifies that the disclosure relates only to conflicts of compensation consultants and not to conflicts of counsel or others.

This new disclosure is required of all companies subject to the requirements of the Exchange Act, not just those listed on a securities exchange or securities association. This disclosure will be required in any proxy or information statement for an annual meeting (or special meeting in lieu of an annual meeting) at which directors will be elected occurring on or after January 1, 2013.

## Recommendations

The new rules relating to heightened independence standards for compensation committee members should not require a radical change in practice or procedures for public companies that are currently complying with NYSE or NASDAQ Stock Market rules. Nevertheless, companies should review their compensation committee charters to ensure that the committee has the authority to engage outside compensation advisers as it deems necessary and appropriate and that the company will provide appropriate funding for such advisers. Companies should also assess the independence of each of their current compensation advisers based on the factors listed above. Companies should also consider amending their D&O questionnaires to elicit the information required to determine independence of compensation committee members, as well as any business or personal relationships they have with compensation consultants or advisers. The ultimate impact will depend on the specifics of the listing standards adopted by the securities exchanges and securities associations as mandated by the new rules.

In addition, compensation committees should evaluate any potential conflicts of interest related to the work of compensation consultants or advisers in light of the new disclosure requirement in Item 407 to determine whether it will have to expand its proxy statement disclosure next year. In anticipation of their effectiveness, issuers may consider asking their compensation consultants what policies and procedures they have in place to prevent conflicts of interest from occurring on their side.

For more information about Rule 10C-1 and amendments to proxy disclosure rules, please contact the author of this alert, **Robert Murphy** at 202-906-8721, **D. Richard McDonald**, who leads Dykema's Public Company practice, at 248-203-0859, or any of the listed attorneys.

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