LEGAL UPDATES

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New Rules Rolled Out for Compensation Committees and Advisors

The Securities and Exchange Commission (SEC) has implemented provisions of the Dodd-Frank Act that require national securities exchanges to maintain certain listing standards related to compensation committees. The rules, adopted June 20, 2012, prohibit exchanges from listing the securities of any company that is not in compliance with the compensation committee and compensation advisor requirements of Section 10C of the Exchange Act of 1934, as amended.

Companies, however, are not required to have a compensation committee under the new rules. For purposes of these rules, the SEC has defined “compensation committee” as follows:

A board committee designated as a compensation committee.

In the absence of such committee, a board committee performing functions typically performed by a compensation committee, including oversight of executive compensation, even if it is not designated as the compensation committee or also performs other functions.

In the absence of either committee, the members of the board of directors who oversee executive compensation matters on behalf of the board.

The following is a summary of the requirements exchanges must incorporate in their listing standards.

Independence of Compensation Committee Members

Members of the compensation committee must be a director and be independent. The exchanges must each develop a definition of independence that should take into consideration factors enumerated by the SEC, including:

The source of compensation of the director, including any type of consulting fee paid to that director.

Whether the director is in any way affiliated with the company, one of its subsidiaries, or an affiliate of one of its subsidiaries.

The SEC declined to conclude that a director affiliated with a significant stockholder was sufficiently independent to be a member of the compensation committee. Instead, the SEC noted that other factors besides share ownership should be considered by the exchanges, including relationships between the board member and the company's management team. Exchanges also have discretion in determining how to address a director's relationships prior to the effectiveness of these rules or to his or her appointment to the compensation committee. If an exchange anticipates that certain relationships may cause problems for its listed companies, it may seek permission from the SEC to exempt those relationships. The SEC has thus granted exchanges a significant degree of flexibility in defining "independence" for purposes of complying with the new rules.

Compensation Advisors

Members of a compensation committee are directly responsible for the appointment, compensation and oversight of compensation advisors, who they may retain at their sole discretion. The advisor must be appropriately funded by the listed company.

The new rules require companies to conduct an independence assessment of any consultant, except for in-house counsel, offering advice to compensation committees. The six factors that compensation committees must consider are:

Whether the compensation consulting company employing the compensation advisor is providing any other services to the company.

How much the compensation consulting company that employs the compensation advisor has received in fees from the company as a percentage of that person's total revenue.

What policies and procedures have been adopted by the compensation consulting company employing the compensation advisor to prevent conflicts of interest.

Whether the compensation advisor has any business or personal relationship with a member of the compensation committee.

Whether the compensation advisor owns any stock of the company.

Whether the compensation advisor or the person employing the advisor has any business or personal relationship with an executive officer of the issuer.

There is no requirement that a company retain a compensation advisor, and the rules do not prohibit a committee from engaging an advisor, including a compensation consultant or outside counsel, who is not independent as long as it considers the six factors set forth above.

Additional Disclosure Necessary

The new rules expand the disclosure requirements of Item 407(e)(3) of Regulation S-K. Companies must disclose in their proxy materials, for any annual meeting of the shareholders after January 13, 2013, whether its compensation committee has obtained the advice of a compensation consultant and the nature and scope of the consultant's assignment. The company must also disclose fees paid to the consultant to specifically advise on director or officer compensation. If the consultant offers advice on matters besides compensation and charges more than $120,000 during a fiscal year, the company must state how the fees have been allocated between director or officer compensation advice and the additional services.

The company must also address whether the compensation advisor has any conflicts of interest and the company's procedures to address that conflict. The term "conflict of interest" is not defined in Section 10C of the Exchange Act or the newly implemented rules. Instead, the SEC added an instruction to Item 407(e)(3) that requires companies to consider, in determining whether a conflict exists, the six independence factors a compensation committee uses to hire a consultant.

The new disclosure requirements, including conflicts of interest, do not apply when a compensation consultant advises on broad-based plans or provides noncustomized benchmark data. Additionally, companies are only required to make disclosures with respect to compensation consultants and not other advisors. The new disclosures required by Item 407 also apply to companies exempt from the compensation committee independence standards, such as controlled companies, nonlisted issuers and smaller reporting companies.

Exemptions and Effectiveness

Smaller reporting companies and controlled companies (where the majority of voting power for director elections is held by a sole investor or group of investors) are exempt from all requirements of the new compensation committee listing standards. Exchanges are also authorized to exempt other categories of issuers after receiving approval from the SEC, which could include emerging growth companies as defined in the recent JOBS Act.

Exchanges may exempt four categories of companies from complying with listing standards relating to compensation committee independence: limited partnerships, companies in bankruptcy proceedings, open-end 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 the foreign private issuer does not have an independent compensation committee.

National securities exchanges will have 90 days after the rules are published in the *Federal Register* to provide the SEC with listing standards that comply with the new rules.

Next Steps for Listed Companies

Companies should begin assessing the extent to which their compensation committees and compensation consultants already comply with the independence factors listed in the new rules. This will help ensure that, first, companies are substantially in compliance when the national exchanges issue their new requirements and, second, that the companies are prepared to make proper disclosures in proxy statements for their 2013 annual meetings.

Contact Info

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