

SEC Takes Next Step to Implement Dodd-Frank Act's Compensation Committee

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The SEC has amended existing proxy disclosure requirements and adopted a new rule to implement the provisions of section 952 of the Dodd-Frank Act relating to compensation committees.¹

The amendment to Item 407(e)(3) of Regulation S-K requires proxy disclosure of compensation consultant conflicts of interest. The new disclosures must be provided in connection with stockholders meetings that are held on or after January 1, 2013. No further rulemaking is required to implement this disclosure requirement.

New Rule 10C-1 under the Exchange Act requires stock exchanges to propose by September 25, 2012 and to have in effect by June 27, 2013 listing standards regarding the independence of compensation committee members and enhanced duties and authority of compensation committees with respect to compensation consultants, legal counsel and other advisers.

Disclosure of Compensation Consultant Conflicts of Interest

All companies that are subject to the SEC's proxy rules (including smaller reporting companies, controlled companies and issuers that are not listed on a stock exchange) will be required to disclose the nature of any conflict of interest arising from the work of any compensation consultant and how that conflict is being addressed. This new disclosure requirement, added as Item 407(e)(3)(iv) of Regulation S-K, applies to compensation consultants that are required to be identified in the proxy statement under existing Item 407(e)(3)(iii) of Regulation S-K.²

An instruction to new Item 407(e)(3)(iv) specifies the following non-exclusive list of factors that should be considered in determining whether a conflict of interest exists:

- the provision of other services to the company by the firm that employs the individual compensation consultant who provides advice;
- the amount of fees received from the company by the firm that employs the compensation consultant, as a percentage of the total revenue of that firm;

- the policies and procedures of the firm that employs the compensation consultant that are designed to prevent conflicts of interest;
- any business or personal relationship of the individual compensation consultant with a member of the compensation committee;
- any stock of the company owned by the individual compensation consultant; and
- any business or personal relationship of the individual compensation consultant or the firm employing the compensation consultant with an executive officer of the company.

Companies should adopt procedures to gather the above information so that the compensation committee can assess whether a conflict exists and take any desired actions in response to any identified conflicts prior to when proxy disclosure is first required.

The new disclosure is required in any proxy or information statement for an annual meeting of stockholders (or a special meeting in lieu of annual meeting) at which directors will be elected occurring on or after January 1, 2013.

Since existing Item 407(e)(3) relates to director compensation as well as executive compensation, to the extent consulting on director compensation raises a conflict of interest on the part of the compensation consultant, disclosure would be required under new Item 407(e)(3)(iv).

Disclosure is not required with respect to compensation advisers other than compensation consultants.

Listing Standards Relating to Compensation Committee Membership

New Rule 10C-1 requires stock exchanges (including the NYSE, the NASDAQ Stock Market, NYSE Amex and NYSE Arca) to adopt listing standards that prohibit the initial or continued listing of a company unless each member of the compensation committee is an independent director.³

The definition of “independence” is left to each exchange to decide by rulemaking. In conducting this rulemaking each exchange must consider the following two factors, together with any other factors it deems relevant:

- a director’s source of compensation, including any consulting, advisory or other compensatory fee paid by the company; and
- whether a director is affiliated with the company, a subsidiary of the company or an affiliate of such subsidiary.

The SEC’s rule does not preclude significant stockholders from serving on the compensation committee, but the SEC emphasized that it is important for each exchange to consider share ownership and other ties between a company and a director when determining the exchange’s definition of independence. The SEC’s rule also does not impose a “look-back” period requiring exchanges to consider relationships prior to a director’s appointment to the compensation committee or, for directors already serving as compensation committee members when the new

listing standards take effect, prior to the effective date of the new listing standards.

Listing Standards Relating to Duties and Authority of Compensation Committee

New Rule 10C-1 also requires stock exchanges to adopt listing standards that prohibit the initial or continued listing of a company unless:

- the compensation committee is empowered, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, or other adviser;
- the compensation committee is directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel and other adviser retained by the compensation committee;
- the company provides appropriate funding, as determined by the compensation committee, for payment of reasonable compensation of advisers retained by the compensation committee; and
- the compensation committee selects its compensation consultants, legal counsel and other advisers only after taking into consideration factors relating to independence of such advisers that are to be specified by the stock exchanges.

The factors relating to the independence of compensation consultants, legal counsel and other advisers that must be included as part of the rules adopted by each stock exchange are the same ones summarized above with respect to the new disclosure requirement relating to compensation consultant conflicts of interest plus any other factors specified by the stock exchange.⁴ The factors are intended to be considered in their totality, and no one factor should be viewed as being determinative.

Rule 10C 1 does not require the compensation committee to retain advisers, to use only independent advisers or to implement or act consistently with the advice or recommendations of any adviser.

The compensation committee is not required to be directly responsible for the appointment, compensation or oversight of compensation advisers that are not retained by the compensation committee, such as compensation consultants or legal counsel retained by management. The committee must, however, conduct an independence assessment with respect to any compensation adviser, other than in-house counsel, that provides advice to the committee.

Scope of, and Exceptions to, Applicability of Listing Standards

The listing standards described above do not apply to any controlled company or to any smaller reporting company.⁵ Additionally, the following issuers are exempted from the compensation committee member independence listing standards: limited partnerships; companies in bankruptcy proceedings; open-end management investment companies registered under the Investment Company Act; and foreign private issuers that provide annual disclosures to stockholders of the

reasons why the foreign private issuer does not have an independent compensation committee. Note that the new proxy disclosure requirements apply to a broader group of companies than the new listing standards.

The stock exchanges may, through rulemaking, exempt particular relationships from the compensation committee member independence requirements and exempt categories of issuers from all of the new listing standards.

Rule 10C-1 only applies to companies with listed equity securities. Therefore, companies whose securities are quoted on the OTC Bulletin Board (OTCBB) and the OTC Markets Group (previously known as the Pink Sheets and Pink OTC Markets) will not be subject to Rule 10C-1, unless their securities are also listed on a national securities exchange.

The listing standards must provide companies with a reasonable opportunity to cure any defects that would be a basis for a prohibition of listing.

New Rule 10C-1 under the Exchange Act requires stock exchanges to propose by September 25, 2012 and to have in effect by June 27, 2013 listing standards regarding the independence of compensation committee members and enhanced duties and authority of compensation committees with respect to compensation consultants, legal counsel and other advisers.

Action Items

Companies should:

1. Put procedures into place now to gather information on the six compensation consultant conflict of interest factors so that the compensation committee can assess whether any conflict exists and take any remedial actions, if desired, prior to when proxy disclosure is first required in connection with stockholder meetings to be held on or after January 1, 2013.
2. Begin to develop procedures for conducting the independence assessment that will eventually be required under listing standards with respect to all advisers (other than in-house counsel) who provide advice to the compensation committee.
3. Monitor the listing standard proposals submitted by both NASDAQ and NYSE, regardless of where the company is listed, given the past tendency of these exchanges to conform their listing standards to one another.
4. Begin to evaluate whether any current member of the company's compensation committee is at risk of not meeting the applicable independence requirements of the exchange where the company is listed and will need to be replaced.

5. Begin to evaluate whether changes need to be made to the compensation committee charter to reflect the committee's new duties and authority.

¹ The changes were adopted by the SEC on June 20, 2012 with an effective date of July 27, 2012. See Listing Standards for Compensation Committees, Exchange Act Release Nos. 33-9330, 34-67220 (June 20, 2012). The SEC had originally proposed rules on March 30, 2011. See Listing Standards for Compensation Committees, Exchange Act Release Nos. 33-9199, 34-64149 (March 30, 2011).

² Existing Item 407(e)(3)(iii), which was added in 2010, requires companies to describe any role of compensation consultants in determining or recommending the amount or form of executive and director compensation (other than certain roles limited to broad-based plans or providing non-customized information). The SEC had proposed amendments to current Item 407(e)(3)(iii) of Regulation S-K which would have integrated the Dodd-Frank disclosure requirements with the existing compensation consultant disclosure provisions, but instead decided to retain the existing requirements of 407(e)(3)(iii) and add a new subparagraph to 407(e)(3) to address the additional disclosures mandated by the Dodd-Frank Act.

³ The new rule does not require that companies have a compensation committee (although NYSE already requires such a committee and the vast majority of NASDAQ companies maintain compensation committees). If a company does not have a designated compensation committee, then the rule will apply to the committee of the board 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 a change from what the SEC originally proposed, if the company does not have a compensation committee or another applicable committee, then the new rule will apply, with limited exceptions, to the members of the board who oversee executive compensation matters on behalf of the board.

⁴ The six required factors are:

(i) The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;

(ii) 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;

(iii) 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;

(iv) Any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;

(v) Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser;
and

(vi) 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.

Examples of “business or personal relationships” include familial relationships or being partners together in a business.

The SEC rule does not require consideration of stock owned by the person that employs the compensation adviser.

⁵ The listing standards also do not apply to the listing of security futures products cleared by a clearing agency that is registered pursuant to Section 17A of the Exchange Act or that is exempt from registration pursuant to Section 17A(b)(7)(A) and standardized options that are issued by a clearing agency that is registered pursuant to Section 17A of the Exchange Act.

Authors



Knute J. Salhus

RETIRED PARTNER

✉ knute.salhus@wilmerhale.com

☎ +1 212 230 8800

Thomas W. White

RETIRED PARTNER

☎ +1 202 663 6000



Jonathan Wolfman

PARTNER

Co-Chair, Corporate Governance
and Disclosure Group

✉ jonathan.wolfman@wilmerhale.com

☎ +1 617 526 6833