

## SEC ISSUES FINAL RULES ON LISTING STANDARDS FOR COMPENSATION COMMITTEES

June 26, 2012

To Our Clients and Friends:

The Securities and Exchange Commission adopted final rules last week to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.<sup>1</sup> The final rules mandate additional disclosure regarding compensation consultants and related conflicts of interest and require the national securities exchanges (*e.g.*, the NYSE and NASDAQ) to adopt new listing standards on the composition of listed companies' compensation committees and their selection of compensation advisers following the general guidelines provided in the new rules. The final rules are similar to the proposed rules that were issued by the SEC last year and do not dramatically change the current stock exchange compensation committee listing standards. Among other things, the final rules:

- require all compensation committee members of listed companies to be independent (with certain exceptions);
- require compensation committees of listed companies to consider six specific independence factors when determining whether to engage a compensation consultant, independent legal adviser or other adviser (although independent advisers are not ultimately required); and
- require all issuers to disclose a compensation committee's use of a compensation consultant and any related conflicts of interest in the issuer's annual proxy statement.

### SCOPE AND TIMING

Compensation Committee Listing Standards. Once the new compensation committee listing standards are adopted by the exchanges, the compensation committees of all listed issuers of equity securities (other than those that are expressly exempt) must meet the applicable standards. Issuers that are exempt from the independence requirements but not the requirements relating to selecting compensation advisers include limited partnerships, companies in bankruptcy proceedings, registered open-end management investment companies and any foreign private

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<sup>1</sup> The SEC's release on the final rules (SEC Adopting Release No. 33-9330) is available at <http://www.sec.gov/rules/final/2012/33-9330.pdf>

issuer that discloses to shareholders the reasons why it does not have an independent compensation committee. Controlled companies and smaller reporting companies are exempt from all of the requirements included in the new listing standards for compensation committees. The exchanges are also authorized to adopt exemptions for other types of issuers, subject to SEC approval.

While the final rules will become effective thirty days following publication in the Federal Register, the exchanges will have 90 days after publication to provide the SEC with proposed rules or amendments to their listing standards. The exchanges' new rules or amendments are required to be finalized within one year of the publication date.

**Disclosure Regarding Compensation Consultants.** The additional disclosure regarding compensation consultants and related conflicts of interest is effective for any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of an annual meeting) at which directors will be elected occurring on or after January 1, 2013. The additional disclosure requirements will apply to any issuer filing a proxy statement or information statement (regardless of whether such issuer is also subject to the new listing standards).

## OVERVIEW OF THE FINAL RULES

### NEW LISTING STANDARD REQUIREMENTS

**Compensation Committee.** The new rules require that each member of a compensation committee be a member of the board of directors of the issuer and independent. The final rules will apply to a listed issuer's compensation committee as well as any committee of the board that performs functions typically performed by a compensation committee (each, a "compensation committee"). The SEC clarified that listed issuers will not, however, be required to have a compensation committee. This differs from the more structured approach taken by the NYSE and the NASDAQ which both set forth specific requirements regarding the members of the board who will be responsible for executive compensation matters. For instance, the NYSE requires that each listed issuer have a compensation committee composed solely of independent directors while the NASDAQ requires that executive compensation matters be determined by either a compensation committee composed solely of independent directors or a majority of the independent directors serving on the board.

The final rules broaden the application of the listing standards initially proposed by the SEC so that they will now apply to members of the board who oversee executive compensation matters on behalf of the board when there is no board committee. As a result, such board members will

now be subject to the requirements relating to director independence, consideration of a compensation adviser's independence and responsibility for the appointment, compensation and oversight of compensation advisers. The proposed rules were limited to the compensation committee and any other committee of the board that was responsible for overseeing executive compensation.

**Independence Standards.** Similar to the proposed rules, the final rules require the exchanges to define independence standards to be applied to members of the compensation committee, after "taking into consideration" "relevant factors," including, but not limited to: (i) the sources of compensation for a member of the board, including any consulting, advisory or other compensatory fee paid by the issuer to such member and (ii) whether a member of an issuer's board is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer. Consistent with the proposed rules (and unlike the current more exhaustive list of independence factors utilized by exchanges such as the NYSE and the NASDAQ), the final rules do not specify any additional factors that the exchanges must consider in determining independence nor do they prescribe any standards or relationships that would automatically preclude a finding of independence. Instead, the exchanges will have the ability to establish their own independence criteria for compensation committee members after considering the factors noted above (which they need not include in the requirements that they ultimately adopt) and any other factors they deem relevant and appropriate, in each case subject to SEC review and approval.

In connection with the proposed rules, the SEC had requested comment on whether a director affiliated with a significant shareholder (such as a private equity fund) who is otherwise independent would be sufficiently independent for purposes of serving on the compensation committee. Upon consideration and in light of the position advocated by many commentators (including Debevoise) that a significant shareholder's stock ownership alone should not preclude directors affiliated with the significant shareholder from serving on an issuer's compensation committee, the SEC determined that such a blanket prohibition would be inappropriate for compensation committees. As such, in the absence of any other disqualifying relationships, affiliates of significant shareholders will be permitted to serve on listed issuers' compensation committees.

Both the NYSE and NASDAQ currently have very specific director independence requirements that would presumably encompass the two factors set forth above. However, the exact standards utilized for these purposes going forward will be left to the discretion of the exchanges so long as the standards are within the parameters established by the SEC.

Authority to Engage Compensation Advisers; Responsibilities and Funding. The new SEC rules require the exchanges to adopt listing standards requiring that the compensation committee of a listed issuer have the authority, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel and other advisers (each a “compensation adviser”). The compensation committee will be directly responsible for the appointment, determining the compensation, and oversight of the work of its compensation advisers but need not implement or act consistently with the advice or recommendations of any compensation adviser. Further, a listed issuer must provide “appropriate funding,” as determined by the compensation committee, for the payment of “reasonable compensation” to its compensation advisers. The compensation committee’s obligations with respect to compensation advisers will not extend to compensation advisers retained by the board of directors as a whole or management.

While the members of the compensation committee (including any board member acting in the absence of a committee) may select any compensation advisers they prefer, the following six independence factors must be considered before selecting a compensation adviser:

- the provision of other services to the issuer by the person that employs the compensation adviser;
- the amount of fees received from the issuer by the person that employs the adviser as a percentage of the total revenue of the person that employs the compensation adviser;
- the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the adviser with a member of the compensation committee;
- any stock of the issuer owned by the adviser; and
- any business or personal relationships between the executive officers of the issuer and the compensation adviser or the person employing the compensation adviser.

An issuer’s compensation committee need not consider these independent factors before consulting with or obtaining advice from in-house counsel. Similar to the proposed rules, the SEC specifically declined to establish any materiality, numerical or other thresholds that would limit the application of any of the enumerated independence factors. Instead, all of the facts and circumstances relevant to the factors specified above should be presented to the compensation committee and viewed in their totality.

Correcting Noncompliance. The exchanges will be required 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.

## NEW DISCLOSURE REQUIREMENTS

Compensation Consultant Disclosure and Conflicts of Interest. The final rules amend Item 407 of Regulation S-K to require additional disclosure regarding an issuer's use of compensation consultants and any related conflicts of interest. This rule applies to all issuers subject to the SEC's proxy rules (whether or not subject to the listing standards described above). Under the final rules and as currently required under Item 407, any such issuer will be required to disclose, in a proxy or information statement for an annual meeting at which directors are to be elected, if a compensation consultant played any role in determining or recommending the amount or form of executive or director compensation, regardless of whether the compensation consultant was retained by management, the compensation committee or any other board committee. These issuers will now also be required to disclose whether the work of the consultant raised any conflict of interest and, if so, a description of the specific conflict and how the conflict has been addressed. The six independence factors described above are among the factors that an issuer "should, at a minimum," consider when determining whether a conflict of interest exists. Consequently, while not expressly required, all issuers may need to consider and disclose its assessment of those factors in the event of a conflict of interest.

## NEXT STEPS

Although the majority of these rules will not take effect until the exchanges propose the related listing standards and those standards are approved by the SEC, issuers and compensation committees can take affirmative steps now to prepare. For example, each issuer should begin implementing policies and procedures relating to the engagement of compensation advisers so that it is in a position to demonstrate that it has, at a minimum, considered the six required independence factors set forth above. While an issuer may still engage whomever it chooses as a compensation adviser (regardless of independence), having such procedures in place will be especially important to comply with the expanded disclosure requirements regarding compensation consultants and related conflicts of interest that will be required in next year's proxies.

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Please do not hesitate to call us if any of the final rules are of concern to you or to discuss the final rules and this memorandum generally.

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