

SEC Adopts Rules Requiring Listing Standards for Compensation Committees and Compensation Advisors

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On June 20, 2012, the Securities and Exchange Commission adopted **final rules** directing stock exchanges to establish listing standards for compensation committees and compensation advisors. The new Rule 10C-1 implements the director independence and other compensation committee standards included in Section 952 of Dodd-Frank (Section 10C of the Securities Exchange Act of 1934, as amended). The final rules also amend Item 407 of Regulation S-K to require additional disclosure on whether the work of any compensation consultants “raised any conflicts of interest,” and if so, how the conflict is being addressed.

Under Rule 10C-1, each member of the compensation committee of a listed issuer must be a member of the board of directors and “independent.” The test for director independence in the new listing standards must include consideration of (a) the source of compensation to a director, including “any consulting, advisory or other compensatory fee paid by the issuer” to the director; and (b) whether the director is “affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.” The stock exchanges may add requirements that go beyond these core considerations. As a result, public companies, depending on how the stock exchanges define independence in the final listing standards, will likely have an additional test of director independence to monitor.

The new rule’s definition of “compensation committee” encompasses (a) a committee of the board of directors that is designated as the compensation committee; (b) a committee of the board of directors performing the functions typically performed by a compensation committee even if it is not designated as the compensation committee or also performs other functions; or (c) in the absence of a committee, the members of the board of directors who oversee executive compensation matters on behalf of the board of directors. This definition allows the stock exchanges to adopt listing standards that will permit issuers to use a variety of committee configurations and practices to satisfy the new standards.

Rule 10C-1 also delineates the authority of compensation committees to hire and use compensation consultants, independent legal counsel and other compensation advisers (collectively, “compensation advisers”). Under the listing standards to be adopted, compensation committees must have the sole authority to hire, and to oversee the work of, compensation advisers retained to advise the compensation committee, as well as funding by the issuer to pay reasonable compensation to compensation advisers. The compensation committee must consider at least six factors listed in the rule that could potentially impact the independence of a compensation adviser before engaging such advisor. The new rules and the adopting release are clear that the compensation committee is not

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required to follow the advice or recommendations of any compensation advisers, that the committee may consult with in-house counsel, advisers retained by the issuer and others as part of its deliberations and that the committee may exercise its own judgment "in fulfillment "of its duties.

The new listing standards will not apply to (a) limited partnerships, (b) companies in bankruptcy proceedings, (c) open-end investment companies registered under the Investment Company Act of 1940, (d) foreign private issuers that disclose that they do not have an independent compensation committee, (e) controlled companies, or (f) smaller reporting companies. The stock exchanges also may grant exemptions for other categories of issuers. The stock exchanges must submit their new listing standards to the Commission no later than 90 days after the rules are published in the Federal Register. The Commission may review any stock exchange submissions and must approve the final listing standards, which must be adopted no later than one year after the publication date. Accordingly, there will be some delay before the new listing standards become effective, although it is likely that the new listing standards will be in place for the 2013 proxy season.

The disclosure called for in new Item 407(e)(3)(iv) of Regulation S-K will be required to be included in any proxy statement for an annual or special meeting of shareholders at which directors will be elected occurring on or after January 1, 2013. In a change from the proposed rules, the Commission determined that the existing disclosure requirements regarding compensation consultants in Item 407(e)(3)(iii) are sufficient for the purposes of Section 952 of Dodd-Frank with the addition of new Item 407(e)(3)(iv). When disclosure regarding a compensation consultant is required under Item 407(e)(3)(iii), the new item requires a statement with respect to such consultant on whether the work of such compensation consultant "raised any conflicts of interest," and, if so, how the conflict is being addressed.

Taken as a whole, the new rules should not require a radical change in practice for public companies that are currently complying with NYSE or NASDAQ Stock Market rules. Public companies will, however, need to be prepared to comply with a new director independence test for members of the compensation committee, and will need to review their committee charters and procedures (particularly as such procedures relate to the compensation committee hiring of compensation advisors) once the final listing standards are adopted. In addition, compensation committees should evaluate any potential conflicts of interest related to the work of compensation consultants in light of the new disclosure requirement.

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