

SEC Adopts Rule Implementing Dodd-Frank Act Requirements for Compensation Committees

On June 20, 2012, the Securities and Exchange Commission (SEC) adopted a rule regarding the new listing standards for compensation committees required by the Dodd-Frank Act of 2010. Final action to implement the listing standards will need to be taken by the applicable securities exchanges including the NYSE and NASDAQ. New SEC Rule 10C-1 establishes the parameters for the final action by the exchanges, giving the exchanges discretion as to some of the new compensation committee requirements subject to final SEC review and approval of each exchange's final standards. The exchanges will have 90 days from the publication of the Rule 10C-1 to propose amended listing standards that comply with the rule and one year to adopt final amended listing standards. The SEC also adopted an amendment to Item 407 of Regulation S-K expanding the disclosure requirements in proxy statements regarding compensation committees.

Application of New Listing Standards

Rule 10C-1 requires an exchange to prohibit the listing or continued listing of any equity security of an issuer that is not in compliance with any part of the rule, subject to appropriate procedures to have a reasonable opportunity to cure any defects. Because the compensation committee requirements in Rule 10C-1 are implemented through the listing standards of securities exchanges, they do not apply to reporting issuers who do not have a class of equity securities listed on an exchange (such as an issuer whose equity securities are traded on the OTC Bulletin Board). However, the proxy statement disclosure requirements in Item 407 of Regulation S-K will apply to any reporting issuer subject to the SEC's proxy rules.

Generally, for purposes of Rule 10C-1, a "compensation committee" is defined broadly to include not only any committee designated as a compensation committee but also any other committee performing functions typically performed by a compensation committee, including oversight of executive compensation, or, if an issuer does not have any such committee, the members of the board of directors who oversee executive compensation matters. The requirements relating to the authority to retain compensation advisers and funding for payment of such advisers do not apply to the members of a board of directors who oversee executive compensation matters in the absence of a

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formal committee.

Independence Standards

Rule 10C-1 provides that each member of a compensation committee must be a member of the board of directors and must be independent under the applicable standards established by the exchange.

Independence Standards. Rule 10C-1 directs each exchange to develop its own definition of independence applicable to compensation committee members. An exchange does not need to have a uniform definition of independence, and can, for example, use a different definition of independence for compensation committee members than for audit committee members. Consistent with the Dodd-Frank Act, the exchanges are directed to consider relevant factors, including (1) a director's source of compensation, including any consulting, advisory or compensatory fee paid by the issuer, and (2) whether a director is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer. Rule 10C-1 does not prohibit all affiliates from serving on the compensation committee (unlike the audit committee rules, which do prohibit affiliates from serving), so an exchange may determine to permit certain affiliates (such as representatives of large shareholders) to serve. Each exchange's final independence standards for compensation committee members will be set by the amended listing standards they propose which are approved by the SEC.

Exemptions. The following categories of listed issuers are exempt from the compensation committee independence requirements:

1. limited partnerships;
2. companies in bankruptcy proceedings;
3. open-end management investment companies under the Investment Company Act of 1940; and
4. any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee.

Rule 10C-1 also authorizes the exchanges to adopt additional exemptions from the independence requirements.

Compensation Advisers

Rule 10C-1 also directs the exchanges to adopt listing standards regarding the retention and funding of compensation advisers, which includes not only compensation consultants but also legal counsel and other advisers.

Authority to Retain Compensation Advisers. Each exchange must adopt a listing standard providing that (1) the compensation committee of a listed issuer must have the authority to retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser and (2) the compensation committee shall be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser retained by it. There is no requirement that a compensation committee actually retain compensation advisers or only obtain advice from independent advisers, and a compensation committee may continue to obtain information and advice from management, inside legal counsel, the issuer's outside legal counsel and others. In addition, a compensation committee is not required to implement or act consistently with the advice or recommendation of any adviser.

Funding. The listing standards also must require that the issuer provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation adviser retained by the compensation committee.

Consideration of Independence Factors. Rule 10C-1 provides that the compensation committee of a listed issuer may select a compensation adviser only after taking into account the following six factors (as well as any additional factors identified by the relevant exchange in its listing standards):

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



executive officer of the firm.

The first three factors apply to the firm that employs the individuals engaged to provide services to the issuer, while the last three factors apply only to the individuals providing services to the issuer.

Rule 10C-1 does not require that a compensation adviser be independent, only that the compensation committee of a listed issuer consider the independence factors before selecting a compensation adviser. The factors are to be considered in their totality, and no one factor should be viewed as a determinative factor of independence.

A compensation committee does not need to consider the independence factors with respect to the issuer's in-house legal counsel, but otherwise must consider the factors with respect to any other compensation consultant, legal counsel or other adviser that provides advice to the compensation committee, including any outside legal counsel engaged by the issuer that provides such advice.

Compliance with Rule 10C-1 will require the compensation committee to implement a process to obtain the necessary information to consider the independence factors.

Exemption for Controlled Companies and Smaller Reporting Companies

Controlled companies and smaller reporting companies are exempt from all of the compensation committee listing standards in Rule 10C-1. A controlled company is defined as a listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company.

New Compensation Committee Disclosure Requirement

The SEC also amended Item 407 of Regulation S-K to require disclosure of the nature of any conflict of interest with a compensation consultant and how the conflict is being addressed. For purposes of this requirement, the SEC stated that the six independence factors described above are among the factors that should be considered in determining whether a conflict of interest exists.

The new conflict of interest disclosure must be included in any proxy or



information statement for an annual meeting (or special meeting in lieu of an annual meeting) at which directors are elected. It will be effective for any meeting at which directors are elected occurring on or after January 1, 2013, and applies to all issuers subject to the SEC's proxy rules, including controlled companies, non-listed issuers and smaller reporting companies.

What to Do Now

Listed issuers will not be required to take any action as to the new compensation committee requirements until the exchanges adopt new listing standards implementing Rule 10C-1. Until that time, there are a few things that an issuer can do to prepare for the changes:

- Update the members of the compensation committee regarding the new rules and the timing for implementation.
- Review the membership of the compensation committee to identify members who may not be independent under the new standards.
- Review the compensation committee charter for potential changes to reflect the new standards (although an issuer should generally wait for the final new listing standards for its exchange before adopting any changes).
- Consider policies and procedures to gather information regarding independence and conflicts of interest for compensation advisers, including not only consulting firms but also outside counsel and other advisers (note that this will apply to the new conflict of interest disclosure for compensation consultants that will be applicable for the 2013 proxy season, which may be before the final amended listing standards are adopted).

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