

# Cooley

July 2, 2012

More than a year after releasing its initial proposal, the SEC has finally adopted new rules that will require the national securities exchanges to adopt new listing standards designed to promote the independence of compensation committee members, consultants and advisers. The final rules conform substantially to the March 2011 proposed rules, with only modest deviations in response to public comments received.

The final release is available at [www.sec.gov/rules/final/2012/33-9330.pdf](http://www.sec.gov/rules/final/2012/33-9330.pdf).

The SEC's rules implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, codified in Section 10C of the Securities Exchange Act of 1934, and closely track its provisions without significant expansion. As a result, the rules require compensation committee independence and establish a baseline of considerations for determining the independence of compensation committee members, consultants, legal counsel and other advisers; however, the exchanges will have flexibility, subject to ultimate SEC approval, to formulate definitions or other requirements consistent with the SEC's rules. The final rules also impose new proxy statement disclosure requirements related to compensation consultants and conflicts of interest.

Although the adopting release makes clear that the new proxy disclosure will be required for the 2013 proxy season, whether the listing standards will become effective in time for next season depends largely on how quickly the exchanges act to implement the new SEC rules and how quickly the SEC approves their proposals.

## **Independent compensation committee members**

Under the final rules, the national securities exchanges must establish listing standards that require each member of a listed company's compensation committee to be a director and to be "independent." The term "independent" is not defined. Instead, the term is to be defined by the exchanges after taking into consideration "relevant factors" prescribed by Section 10C and reflected in the SEC's final rules, including the following:

- the source of compensation of a member of the board of directors, including any consulting, advisory or other compensatory fee paid by the company to that director; and
- whether a director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

These factors largely parallel the requirements for audit committees mandated by the Sarbanes-Oxley Act of 2002. Similar to its approach to the definition of audit committee independence, the SEC did not impose a mandatory look-back requirement, relying instead on the look-back periods already required by the exchanges in evaluating director independence generally.

Unlike the rules for audit committees, the final rules do not define the term "affiliate" or provide a safe harbor for affiliate status. The SEC seemed to accept the contention by commentators that there may be good reasons not to impose the same bright-line prohibitions on affiliate participation on compensation committees as were imposed with respect to audit committees, particularly where affiliate status is based on stock ownership. For example, affiliates who represent significant investors may be especially rigorous in their oversight of executive compensation and could have interests closely aligned with smaller shareholders.

## *Observations and commentary*

- In contrast to the audit committee requirements imposed under Sarbanes-Oxley, the independence factors identified by Congress in Section 10C, and consequently by the SEC in its final rules, do not impose a full-stop disqualification for

compensation committee membership, but rather represent only factors to be considered in determining a member's independence. The SEC interprets this difference to reflect a Congressional intent to allow the exchanges more discretion in developing definitions of "independence," taking into account the relative average sizes of the boards of companies listed on the various exchanges as well as the potentially disparate expectations of these companies' investors. Nevertheless, the exchanges may well conclude that the identification of these two factors by Congress in Section 10C reflects a Congressional determination that these factors are likely to compromise director independence. As a result, it would not be entirely surprising to find that some exchanges include these factors as mandatory disqualifications in their independence definitions.

- For now, until listing standards are at least proposed by the exchange on which a company is listed, the company may make only preliminary assessments as to whether its current compensation committee members would run afoul of potentially mandatory disqualifications based on the two enumerated factors (or may otherwise be compromised under less compulsory standards) and begin to think about whether other directors are available to replace any directors who may be determined not to be independent for this purpose.
- In the adopting release, the SEC emphasized that, because circumstances and relationships could cause the interests of large and small shareholders to diverge, the exchanges are urged to consider, in developing their definitions, whether "other ties between a listed issuer and a director, in addition to share ownership, might impair the director's judgment as a member of the compensation committee." Although the SEC did not identify any additional factors that should or must be considered, it did suggest that the exchanges "might conclude" that the definition of independence should address business or personal relationships between a compensation committee member and executive officers of the listed company. Notably, the SEC observed that commentary in the NYSE Listed Company Manual related to the definition of independence highlights that "the concern is independence from management." As a result, in anticipation of the possibility of an explicit listing standard directed at independence from management, companies listed on the NYSE (or perhaps even on other exchanges) may want to consider whether there are any relationships that could compromise committee members' independence from that perspective.

#### **Compensation consultants, legal counsel and other advisers**

**Authority to engage.** Consistent with Section 10C, the final rules direct the exchanges to adopt listing standards that require that compensation committees of listed companies be:

- authorized, in their sole discretion, to retain or obtain the advice of compensation consultants, independent counsel and other advisers;
- directly responsible for the appointment, compensation and oversight of the work of compensation consultants and other advisers retained by the committee; and
- entitled to appropriate funding from the listed company to pay reasonable compensation to the committee's consultants, counsel and advisers.

The rules provide that committee members must still be able to exercise their own judgment in fulfilling their duties, with no obligation to implement or act consistently with the advice or recommendations of compensation consultants, counsel or other advisers.

**Independence of consultants, legal counsel and other advisers.** Under the final rules, the exchanges are also directed to adopt listing standards that address the independence of compensation committee consultants, counsel and other advisers.

Compensation committees are not required to select consultants, counsel or other advisers that are "independent," but instead, in making their selections, compensation committees must take into account the following six factors, drawn largely from Section 10C, which bear upon independence:

- the provision of other services to the company by the employer of the compensation consultant, counsel or other adviser (referred to in this Alert as the "advisory firm," as distinguished from the individual adviser);
- the amount of fees received from the company by the advisory firm, as a percentage of the advisory firm's total revenue;
- the advisory firm's policies and procedures that are designed to prevent conflicts of interest;

- any business or personal relationship of the compensation consultant, counsel or other adviser with a member of the compensation committee;
- any stock of the company owned by the compensation consultant, counsel or other adviser; and
- any business or personal relationship between an executive officer of the company and the compensation consultant, counsel, other adviser or the advisory firm.

The final factor was added in response to commentators who stated that business and personal relationships between an executive officer and a compensation adviser, such as a familial relationship or business partnership, may pose a significant conflict of interest that should be considered by the compensation committee before selecting the adviser. Note that the SEC does not view stock ownership of the advisory firm (as opposed to the individual adviser) to be covered by the final rule. Similarly, independence under the rules is not affected by personal or business relationships that the advisory firm may have with members of the compensation committee (as opposed to executive officers of the company). However, the SEC does note that stock owned by the individual adviser does include stock owned by immediate family members. Because bright-line thresholds may not be "competitively neutral" (as between multi-service and boutique compensation consulting firms), the final rules do not provide for any materiality or bright-line numerical thresholds related to stock ownership, amount of revenues or any of the other factors. Although the SEC believes the factors identified are generally comprehensive, the exchanges have discretion to identify other independence factors that must be considered by compensation committees of listed companies.

The SEC believes that these factors, when considered in the aggregate, are "competitively neutral" because the compensation committee will be required to consider a variety of factors that bear upon whether the adviser is likely to provide independent advice, but will not be prohibited from selecting any particular adviser. The SEC agreed that no one factor should be viewed as determinative of independence. The final rules do not require that the committee's selection process be described in the company's proxy statement.

In response to comments, the SEC included in the final rules an instruction that the compensation committee need not consider the six independence factors before consulting with or obtaining advice from in-house legal counsel; as company employees, such counsel are not held out to be independent. However, the compensation committee will be obligated to consider the independence of outside legal counsel (including outside company counsel), as well as other advisers, that provide advice to the compensation committee.

**Opportunity to cure defects.** As required by Section 10C, the final rules require the exchanges to establish procedures giving companies a reasonable opportunity to cure any defects that would be the basis for delisting for non-compliance with the new listing standards. The SEC believes that existing continued listing or maintenance standards and delisting procedures of most of the exchanges would already satisfy this requirement. As with the rules related to audit committee members, the final rules allow the exchanges to provide that, if a member of a compensation committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the company to the applicable exchange, may remain a compensation committee member until the earlier of the next annual meeting of the listed company or one year from the occurrence of the event that caused the member to be no longer independent. No special exceptions are provided for newly listed companies; however, the exchanges are authorized to exempt categories of companies from the listing standards, and any of the exchanges could establish new exceptions in those circumstances, including phase-in provisions for newly public companies similar to those that currently apply to other board and committee composition requirements.

#### *Observations and commentary*

- Whether or not compensation committees will feel pressured by the new rules to engage independent advisers remains to be seen. Responding to concerns expressed by a number of commentators, the SEC emphasized that neither Section 10C nor the final rules require a compensation adviser to be independent, only that the committee consider the independence factors above before selecting an adviser. The SEC believes that, irrespective of the decision a committee makes, information gathered as a

result of the independence assessment will itself be useful to the committee in considering any advice that the advisers may provide.

- Although there is not yet any specific deadline for decision-making, it is not too early for committees to begin discussing what principles will guide them. A compensation committee should begin now to determine what its policy will be in assessing the independence of both current and future advisers and whether that policy should be in written form and publicly disclosed. The policy likely should include the committee's review of the policies of its advisers and prospective advisers to ensure that these advisers will be able to provide information requested by the committee and comply with any independence requirements imposed by the committee.

### **Broad application of the new listing standards**

By their terms, the requirements for new listing standards set forth in Section 10C apply only to compensation committees. However, nothing in Section 10C, as interpreted by the SEC, requires a listed company to have a compensation committee or even a committee that performs functions typically assigned to a compensation committee. Notably, while the listing standards of the NYSE require listed companies to have compensation committees, the NASDAQ listing standards do not, requiring only that executive compensation be determined or recommended to the board either by an independent compensation committee or by a majority of the board's independent directors in a separate vote.

The new rules do not take the leap of obligating listed companies to establish compensation committees; instead, the SEC requires that the listing standards apply more broadly. In the absence of a committee designated as a compensation committee, the listing standards will apply to any committee of the board that oversees executive compensation and otherwise performs functions typical of a compensation committee, even if not formally designated as such. Moreover, in a change from the proposed rules, the listing standards discussed above will apply to the members of the board who oversee executive compensation matters on behalf of the board, even if not formally acting as a committee. Apparently, the SEC's reluctance, at the proposal stage, to exceed the literal mandate of Section 10C was trumped by its interest in ensuring that executive compensation be overseen by directors who are independent and by concern that companies might seek to circumvent the listing standards by dissolving (or not establishing) compensation committees. The listing standards related to authority to retain advisers and the entitlement to funding for compensation advisers were not extended outside of a formal committee structure; the SEC viewed it as unnecessary to extend those requirements because actions outside of a formal committee are considered actions taken by the full board, which already has that authority.

#### *Observations and commentary*

- Because most listed companies, even those listed on NASDAQ, do have formal compensation committees, we do not expect the SEC's extension of the application of the listing standards in the absence of a formal committee to have a significant impact.

### **Exemptions**

The final rules provide an exemption from the listing standard requirements for controlled companies (defined as companies in which more than 50% of voting power in the election of directors is held by an individual, a group or another company) and, in a change from the proposal, smaller reporting companies (generally, companies with a public float of less than \$75 million).

In addition, the final rules exempt from the compensation committee member independence listing standards limited partnerships, companies in bankruptcy, registered open-end management investment companies and foreign private issuers that disclose annually the reasons that they do not have independent compensation committees. The exchanges are also granted authority to exempt particular relationships and to adopt other exemptions as appropriate.

#### *Observations and commentary*

- Because smaller reporting companies typically have less complex executive compensation arrangements, as well as smaller

boards of directors with fewer independent directors, the SEC concluded that the burden of compliance with these new listing standards was not warranted for those companies.

### **Compensation consultant disclosure and conflicts of interest**

Section 10C requires each listed company to disclose in its annual meeting proxy statement whether its compensation committee retained or obtained the advice of a compensation consultant, whether the work of the consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Under the final rules, if a compensation consultant played any role in determining or recommending the amount or form of executive or director compensation and the consultant's work has raised any conflict of interest, disclosure will be required regarding the nature of the conflict and how it is being addressed. This disclosure will be required regardless of whether the consultant was retained by management, the compensation committee, another board committee or the full board. As noted in the proposal, a general description of the company's policies and procedures to address conflicts would not suffice. The SEC decided not to impose the burden of disclosure for compensation advisers other than compensation consultants or for relationships that create only the appearance of, or potential for, a conflict of interest, as opposed to an actual conflict.

A new instruction will provide that, for purposes of determining whether a conflict exists, committees should, at a minimum, take into account the six independence factors enumerated above that compensation committees must consider when evaluating the independence of compensation advisers.

In a reversal of the proposed rules, with regard to conflict-of-interest disclosure, the final rules retain the exemption from disclosure in the current rules for consulting in connection with broad-based plans and non-customized survey data. The final rules apply these disclosure requirements to all companies subject to the proxy rules, including controlled companies, unlisted companies and smaller reporting companies.

#### *Observations and commentary*

- When the rules were proposed, the SEC indicated that it did not intend that the presence or absence of any of these individual factors, or even disclosure of the payment of fees, would necessarily indicate the presence of a conflict of interest. Likewise, in this facts-and-circumstances determination, other circumstances or factors might well be indicative of a conflict of interest. Presumably, that guidance is still applicable under the final rules.
- The disclosure requirement will become applicable regardless of whether listing standards have yet been adopted. As a result, committees may want to begin to identify, based on the six enumerated factors, any conflicts that may exist with their current compensation consultants and to consider how best to address those conflicts. Although not expressly required, in assessing whether a conflict of interest exists, listed companies may also want to take into account any additional factors regarding compensation adviser independence that are identified by the relevant exchange in the future.

### **Effective dates**

Under the final rules, the exchanges will have until September 25, 2012 to propose new listing standards that comply with the new rules and until June 27, 2013 to obtain final SEC approval of the new standards. In addition, the SEC stated in its discussion of the final rules that, in view of the time that will be necessary for companies to implement disclosure controls and procedures required to collect and analyze information to determine whether their compensation consultants have a conflict of interest, compliance with the new disclosure requirements will be effective for any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013. Accordingly, the final rules will not require any new or modified disclosure in proxy statements for meetings held through the end of 2012.

If you have any questions about this *Alert*, please contact one of your Cooley team members or one of the attorneys identified above.

This content is provided for general informational purposes only, and your access or use of the content does not create an attorney-client relationship between you or your organization and Cooley LLP, Cooley (UK) LLP, or any other affiliated practice or entity (collectively referred to as “Cooley”). By accessing this content, you agree that the information provided does not constitute legal or other professional advice. This content is not a substitute for obtaining legal advice from a qualified attorney licensed in your jurisdiction and you should not act or refrain from acting based on this content. This content may be changed without notice. It is not guaranteed to be complete, correct or up to date, and it may not reflect the most current legal developments. Prior results do not guarantee a similar outcome. Do not send any confidential information to Cooley, as we do not have any duty to keep any information you provide to us confidential. This content may be considered **Attorney Advertising** and is subject to our [legal notices](#).

---

## Key Contacts

Kenneth Guernsey San Francisco	kguernsey@cooley.com +1 415 693 2091
Cydney Posner San Francisco	cposner@cooley.com +1 415 693 2132
Sam Livermore San Francisco	slivermore@cooley.com +1 415 693 2113
Tom Reicher San Francisco	treicher@cooley.com +1 415 693 2381
Nancy Wojtas Palo Alto	nwojtas@cooley.com +1 650 843 5819
Brent Siler Washington, DC	bsiler@cooley.com +1 202 728 7040

---

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2023 Cooley LLP, 3175 Hanover Street, Palo Alto, CA 94304; Cooley (UK) LLP, 22 Bishopsgate, London, UK EC2N 4BQ. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley LLP as the author. All other rights reserved.

