

## Executive Compensation Alert:

SEC Adopts Final Rules for Determining Independence of Compensation Committees and Compensation Consultants

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### Summary

On June 20, 2012, the Securities and Exchange Commission (“SEC”) adopted final rules (“Final Rules”) to implement Dodd-Frank Act Section 952, requiring national securities exchanges to prohibit the initial or continued listing of any stock of a company that does not satisfy compensation committee independence criteria and compensation adviser independence criteria. The Final Rules also include new SEC disclosure requirements relating to the use of compensation consultants and related conflicts of interest.

The Final Rules (available [here](#)), which include several modifications from the proposed rules, will become effective 30 days after publication in the Federal Register. Each national securities exchange and national securities association must submit to the SEC, no later than 90 days after publication of the Final Rules in the Federal Register, proposed rule change submissions (which the SEC must approve) to implement the listing standards. Such Final Rules must be effective no later than one year after publication in the Federal Register. (By contrast, new disclosure rules adopted by the SEC will apply to proxy statements for annual meetings that occur on or after January 1, 2013.)

### Compensation Committee Member Independence

#### *Applicability*

The Final Rules require national securities exchanges (e.g., NYSE and NASDAQ) to adopt listing standards for independence criteria for members of compensation committees, as well as any other Board committee which performs functions typically performed by a compensation committee, including oversight of executive compensation (in either case, “Compensation Committee”). The Compensation Committee must consist solely of members of the Board who are independent. The Final Rules will also require the new listing standards to apply to independent directors who oversee executive

compensation in lieu of a Board committee. But, notably, the Final Rules do not require the issuer to have a Compensation Committee.

#### *Consideration of Relevant Factors*

The Final Rules do not include a uniform definition of “independence.” The SEC instructed the exchanges to establish their own definition (which may differ by exchange) after taking into consideration “relevant factors” that the Dodd-Frank Act mandated, provided that the factors must include:

- the source of the Board member’s compensation, including any consulting, advisory or other fees paid by the issuer; and
- whether a Board member is affiliated with the issuer or any subsidiary of the issuer.

The SEC did not require any additional factors to be considered by the exchanges in establishing their rules. However, it is permissible and possible for the exchanges to consider (and the SEC encouraged the exchanges to consider) additional relevant criteria for determining if a Compensation Committee member is independent (or whether a member of the Compensation Committee could be affiliated), such as share ownership and personal or business relationships between a director and the executive officers of an issuer, factors the SEC considered in the proposed rules, but elected to omit from the Final Rules. The independence requirements developed by the exchanges will be subject to review and final approval by the SEC.

#### *Comparison to Audit Committee Member Independence*

Unlike the Sarbanes-Oxley Act and Rule 10A-3, which prohibit certain persons from serving as Audit Committee members due to their relationship with the issuer, the Dodd-Frank Act and the Final Rules provide the exchanges

with flexibility in establishing Compensation Committee independence criteria. The Final Rules do not contain any mandatory disqualifications from membership. The SEC noted that certain investors (such as venture capital firms or private equity funds) who serve as directors may be well qualified to serve on Compensation Committees. Such directors are often well-positioned to exercise independent judgment regarding compensation due to their familiarity and experience in their industry sector and offer perspectives which are largely in line with those of other shareholders.

The Final Rules follow Rule 10A-3 in providing for an opportunity to cure defects in Compensation Committee member independence, by requiring the exchanges to establish procedures to permit a Compensation Committee member who ceases to be independent for reasons outside the member's control to remain in such position until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member no longer to be independent.

### **Compensation Consultants and Advisers**

#### *Authority to Engage*

The Final Rules require the national securities exchanges to adopt listing standards that require the Compensation Committee to take into account certain factors, in its discretion, when selecting and obtaining the advice of compensation consultants, independent legal counsel and other advisers (collectively, "Compensation Advisers"), with the issuer responsible for their appropriate funding as determined by the Compensation Committee.

The Compensation Committee must also be directly responsible for the appointment, oversight and compensation of any Compensation Adviser retained by the Compensation Committee, and the Final Rules expand this responsibility to the members of the Board who in the absence of a Board committee oversee executive compensation matters on behalf of the Board. However, this oversight requirement does not extend to any outside legal counsel or Compensation Adviser

retained by management or to the legal counsel of the issuer. The Final Rules also clarify that the Compensation Committee (or the Board) is not required to obtain advice only from independent advisors or to follow the advice or recommendation of any Compensation Adviser. The Final Rules also make clear that a Compensation Committee is specifically permitted to exercise its own judgment in fulfillment of its duties.

#### *Independence of Compensation Advisers*

The Final Rules require Compensation Committees to take into consideration the following independence factors when selecting, or obtaining advice from, Compensation Advisers:

- The provision of other services to the issuer by the employer that employs the Compensation Adviser;
- The amount of fees received from the issuer by the employer that employs the Compensation Adviser as a percentage of the employer's total revenue;
- The policies and procedures of the employer that employs the Compensation Adviser that are designed to prevent conflicts of interests;
- Any business or personal relationship of the Compensation Adviser with a member of the Compensation Committee;
- Any stock of the issuer owned by the Compensation Adviser; and
- Any business or personal relationships between the issuer's executive officers and the Compensation Adviser or the entity that employs the Compensation Adviser.

The SEC expressed its view that these six factors should be considered in their totality but that no one factor should be viewed as a determinative factor of independence. However, the Final Rules do not indicate any materiality, numerical or other threshold test. The exchanges *may* also consider other independence factors in adopting their Compensation Adviser independence listing criteria. The SEC chose not to adopt specific materiality or numerical or other bright-line thresholds with respect to the Compensation Adviser independence factors.

The Final Rules clarify that issuers may receive and obtain advice from non-independent counsel (such as in-house counsel or outside legal counsel retained by management). However, Compensation Committees are required to assess the six factors above prior to consulting with or obtaining advice from any such person, other than in-house legal counsel.

The Final Rules do not require issuers to describe the process for selecting Compensation Advisers. The SEC acknowledged that such disclosure would increase the length of the proxy statement disclosures on executive compensation without necessarily providing additional material information to investors.

### Disclosure and Conflicts of Interest

The Final Rules address the additional disclosure requirements effective for proxy statements for annual meetings that occur on or after January 1, 2013 in their annual meeting proxy statements. These requirements are:

- Whether the Compensation Committee has retained or obtained the advice of a compensation consultant; and
- Whether the work of any compensation consultant has raised any conflict of interest, and if so, the nature of the conflict and how the conflict is being addressed.

The Final Rules require an additional disclosure requirement disclosing whether any compensation consultant played any role in determining or recommending the amount or form of executive and director compensation *and* whether the work of such compensation consultant has raised any conflict of interest *and*, if so, the nature of the conflict and how the conflict is being addressed. The SEC limited this disclosure requirement to compensation consultants only, specifying it does not extend to outside legal counsel or other Compensation Advisers to the Compensation Committee.

The Final Rules do not define “conflicts of interest” and instead will include an instruction to Regulation S-K Item 407(e) directing issuers to consider the same six Compensation Adviser independence factors discussed above (plus any additional factors the exchanges may identify) when deciding whether there is a conflict of interest that needs to be disclosed. However, issuers will not be required to disclose potential conflicts of interest or an appearance of any conflict of interest.

No disclosure is required with respect to broad-based plans or non-customized benchmark data. This type of compensation consulting work is not viewed as raising conflict of interest concerns.

### Timeline

Once final SEC rules are published in the Federal Register, the exchanges will have 90 days to propose their new listing standards and one year to obtain final SEC approval of the new listing standards. Issuers will be required to comply with the new disclosure rules under Regulation S-K Item 407(e)(3)(iv) for all annual meeting (or special meeting) proxy statements for which directors will be elected occurring on or after January 1, 2013.

**For more information, you may contact any attorney in the Executive Compensation and Employee Benefits Group at Fenwick & West LLP.**

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