

## WIGGIN AND DANA

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### ABOUT THE SECURITIES AND CAPITAL MARKETS PRACTICE GROUP

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## *SEC Issues Final Rules on Compensation Committee Independence and Disclosure*

As corporate boards continue to struggle with issues surrounding executive compensation, new rules will mean new challenges. The Securities and Exchange Commission ("SEC") recently adopted rules requiring national securities exchanges to adopt listing standards on compensation committee and adviser independence, and enhancing disclosure requirements regarding the role of consultants in determining compensation.

### NEW DODD-FRANK RULES: SEC RULE 10C-1 AND AMENDED ITEM 407 OF REGULATION S-K

Section 952 of the Dodd-Frank Act amended the Securities Exchange Act of 1934 (the "Exchange Act") to add Section 10C, which directs the SEC to promulgate rules regarding compensation committee membership and compensation adviser requirements. On June 20, 2012, the SEC released final rules under the Exchange Act and the Securities Act of 1933, adding Rule 10C-1 and amending Item 407 of Regulation S-K. These SEC rules reform compensation committee practices by: (1) requiring exchanges to establish, as a condition for listing, criteria regarding the independence of compensation committee members, (2) empowering compensation committees' retention of compensation advisers and (3) mandating the disclosure of consultants' conflicts of interests in annual proxy materials. Specifically:

- **Rule 10C-1(a)** instructs national securities exchanges to prohibit the listing of equity securities by any issuer that does not conform to the exchange's standards on compensation committee membership. The SEC took a functional approach in defining compensation committee by including within the definition any member of a board of directors who performs a function typically associated with a compensation committee.

- **Rule 10C-1(b)** sets out the required standards for compensation committees, including the requirement that compensation committees are to be directly responsible for the appointment, compensation and oversight of any compensation advisers retained by the compensation committee. Additionally, prior to receiving advice from any compensation adviser, the compensation committee must evaluate the adviser based on six independence factors found in Rule 10C-1(b)(4). Compensation advisers include compensation consultants, outside legal counsel and other advisers.

- **Item 407(e)(3)(iv)** of Regulation S-K implements Exchange Act Section 10C(c)(2)'s disclosure requirements by mandating that certain information be included in company proxy materials. Companies must disclose the use of any compensation consultants retained or obtained by the compensation committee and whether the work of any compensation consultant has raised any conflicts of interests. If an actual conflict was found, the nature of the conflict and how the conflict is being addressed must also be disclosed.

### WHAT COMPANIES WILL HAVE TO DO

In order to comply with the rules described above, companies will have to address the following:

- **Independence of Directors - Assure that each member of the compensation committee is independent.** In addition to other relevant factors in evaluating the independence of a director, each exchange will consider the source of compensation and any affiliations of a director. Exchanges have the flexibility to develop their own standards and will likely maintain or build on existing requirements.<sup>[1]</sup> Independence

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requirements for compensation committee members are not expected to be as stringent as those for audit committee membership under the Sarbanes-Oxley Act and, thus far, there are no blanket prohibitions or bright-line rules.<sup>[2]</sup>

- **Oversight of Compensation Advisers - Revise corporate charters to require an independence assessment of all compensation advisers and give the compensation committee the authority to engage advisers.** A compensation committee may select a compensation adviser only after taking into consideration the following factors, as well as any other factors required by the relevant exchange:
  - a. Other services to the issuer by the compensation adviser
  - b. Percentage of revenue from fees received from the issuer by the compensation adviser, in terms of the adviser's total revenue;
  - c. Policies and procedures by the compensation adviser designed to prevent conflicts of interest;
  - d. Any business or personal relationship between the compensation adviser and a member of the compensation committee;
  - e. Any business or personal relationships between the executive officers and the compensation adviser; and
  - f. Any stock of the issuer owned by the compensation adviser.

In addition, in order to meet listing standards, compensation committees will be required to have the authority to hire compensation advisers, have access to appropriate funding from the company for payment of reasonable compensation to the compensation advisers and directly supervise any such advisers retained by the compensation committee. The rules

do not require compensation advisers to be independent, only for the company to undertake an independence analysis, and compensation committees are under no obligation to retain their own advisers. SEC guidance states advisers should be evaluated holistically, with no one factor being controlling, and compensation committees are not required to disclose their process for selecting among advisers. In-house counsel serving as a compensation adviser will be exempt from the independence analysis. Finally, compensation committees have no obligation to act consistently with the advice of the compensation advisers.

- **Reporting in Proxy Statements - Enhance compensation consultant disclosure in proxy statements.** If compensation consultants play *any* role in determining or recommending executive and director compensation, the disclosure requirements of Item 407(e)(3)(iv) are triggered. In addition to existing disclosure requirements, proxy statements must now disclose whether the compensation committee has retained or obtained a compensation consultant and any actual conflict of interest of the compensation consultant (and what remedial measures will be taken in connection with any conflict). The "any role" trigger applies regardless of whether the compensation consultant was engaged by management or the compensation committee. The SEC preserved the exemption for advisers consulting on broad-based plans or providing non-customized benchmark data. The disclosure requirements of Item 407 apply to all companies subject to SEC proxy rules.

## IMPLEMENTATION DATES

The exchanges are required to submit revised listing standards to the SEC for approval by September 25, 2012 and final standards by June 27, 2013. It is likely companies will have a transition period to comply with the listing requirements. The disclosure obligations detailed in Item 407 of Regulation S-K become effective for any proxy or information statement with respect to the election of directors on or after January 1, 2013. In the meantime, corporate boards should prepare for the new regulations.

Executive compensation continues to attract attention from the press, regulators and politicians. Compensation committees should anticipate new scrutiny as they adapt to the SEC rules. In light of the increased attention, compensation committee members must be fully informed of the costs and benefits of their decisions in order to justify their recommendations to the full board.

[1] See, e.g., NYSE Listed Company Manual Section 303A.05 and NASDAQ Rule 5605(d).

[2] The independence criteria do not apply to controlled companies, limited partnerships, companies in bankruptcy proceedings, open-end management investment companies, and any foreign private issuer who explains in its annual report the reasons for not having an independent compensation committee. A "controlled company" is defined in Section 10C as a company in which more than 50 percent of the voting power is held by an individual, a group or another company.

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