

# KIRKLAND ALERT

June 2012

## SEC Adopts Final Compensation Committee Independence and Related Rules

### *Exchanges Directed to Adopt Listing Standards*

#### *Summary*

On June 20, 2012, the SEC adopted final rules to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).<sup>1</sup> As required by the Dodd-Frank Act, the rules direct the national securities exchanges to draft listing standards establishing independence requirements for the compensation committees of listed issuers’ boards of directors. As expected, the SEC has left to the exchanges the task of defining “independence.” The SEC reiterated that the Dodd-Frank Act requires the exchanges to consider certain criteria in formulating their listing standards, but gives exchanges discretion to establish their own independence definitions. Notably, the SEC made clear that the exchanges are not required to adopt rules mirroring the audit committee requirements precluding directors affiliated with significant shareholders from serving on compensation committees. Exchanges must propose revised listing standards within 90 days after the SEC’s rules are published in the Federal Register, and final revised listing standards must be approved by the SEC within one year after the SEC’s rules are published in the Federal Register.

In addition, the rules supplement existing proxy disclosure requirements regarding compensation consultants, requiring disclosure of any conflicts of interest. Issuers must comply with the proxy disclosure changes in any proxy statement for an annual or special meeting occurring on or after January 1, 2013 at which directors will be elected.

#### *Independence of Compensation Committee Members*

The final rules direct the exchanges to adopt listing rules that require a listed issuer’s compensation committee to consist entirely of independent directors. For those issuers without a formal compensation committee, the rules will apply to those directors who oversee executive compensation matters on behalf of the board of directors. The standards that will determine independence must be set by the exchanges, subject to final SEC review. Each exchange must consider at least the following factors, but may identify additional ones: (1) the director’s current sources of compensation, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors and (2) whether the director is affiliated with the issuer. Unlike the independence standards for audit committee members, which statutorily define certain required independence thresholds, the exchanges do not need to treat either of these factors, or any additional factors, as being preclusive of independence.

Importantly, the rules will not require the exchanges to prohibit affiliates of an issuer from serving on a compensation committee, although other factors affecting independence must still be considered. The SEC notes that “[t]he exchanges may determine that, even though affiliated directors are not allowed to serve on audit committees, such a blanket prohibition would be inappropriate for compensation committees, and certain affiliates, such as representatives of significant shareholders, should be permitted to serve.”

#### *Authority and Funding to Engage Compensation Advisers*

The final rules also direct the exchanges to adopt listing rules that require a listed issuer’s compensation committee to have the authority and the funding to engage a compensation consultant, legal counsel and other advisers, which the compensation committee is directly responsible to oversee. The rules do not, however, require a compensation committee to actually engage such an adviser, or, once engaged, to follow the adviser’s advice. The rules also do not prohibit management from separately engaging a compensation consultant, legal counsel or other adviser.

If a compensation committee chooses to engage a compensation consultant, legal counsel or other adviser, the rules adopted by the exchanges must require the committee to first consider the independence of such adviser. After consideration, however, the compensation committee may still choose to retain a non-independent adviser. In addition to any additional factors identified by the exchanges in their listing standards, the SEC’s rules

require compensation committees to consider the following six independence factors:

- (1) other services provided by the adviser to the issuer;
- (2) the relative importance of revenue from the issuer to the adviser;
- (3) the adviser's internal policies for avoiding conflicts of interest;
- (4) any other business or personal relationship between the adviser and a member of the compensation committee;
- (5) any stock of the issuer owned by the adviser; and
- (6) any business or personal relationships between the adviser and an executive officer of the issuer.

The final rules retained the existing exception that does not require disclosure about consulting limited to broad-based plans and the provision of non-customized benchmark data.

### *Exemptions*

The independence rules will not apply to limited partnerships, companies in bankruptcy, open-ended management investment companies registered under the Investment Company Act of 1940 or any foreign private issuer that discloses in its annual report the reasons it does not have an independent compensation committee. Neither the independence rules nor the rules relating to compensation advisers will apply to controlled companies or smaller reporting companies. The exchanges are tasked with implementing the final rules through their listing standards and are free to exempt other classes of issuers.

### *Compensation Committee Disclosure Requirements*

The final rules keep the existing disclosure requirements for compensation consultants without change but add a new requirement to provide additional disclosure if the work of a compensation consultant has raised any "conflict of interest" (which is defined by referencing the list of six independence factors discussed above) including the nature of the conflict and how the conflict is being addressed. No disclosure is required about potential conflicts of interest or the ap-

pearance of a conflict of interest. In contrast to the requirement discussed above to consider the independence of any compensation adviser, the disclosure requirements only apply to compensation consultants, and not to legal counsel or other advisers of the compensation committee.

These disclosure requirements apply to all issuers filing proxy statements, including controlled companies (smaller reporting companies are not required to provide disclosure required by Item 407(e)). As a result, even though a controlled company will not be required to consider independence when engaging a compensation consultant, such an issuer will still need to evaluate the consultant's independence for purposes of their proxy disclosure.

### *Action Items*

- **Review Committee Charter.** Listed issuers should consider whether their current compensation committee charters will need to be amended to specifically allow the engagement and payment of compensation advisers.
- **Evaluate Committee Membership.** Listed issuers should also perform a preliminary evaluation of the independence of the current members of their compensation committee, based on the broad constructs outlined in the SEC release. No decisions should be made until the exchanges publish their listing standards.
- **Prepare for Proxy Disclosure and Make Necessary Changes Now.** Issuers that file proxy statements must be prepared to evaluate and disclose in upcoming proxy statements for meetings held after January 1, 2013 any conflicts of interest identified with respect to any compensation consultants who played a role in determining executive and director compensation and to disclose how the conflict is being addressed. Because the proxy disclosure rules look backward (i.e., FY 2012), issuers have the opportunity to review any existing conflicts of interest and any related disclosure that would be required and make any desired changes now to their existing policies, practices and arrangements.

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<sup>1</sup> A copy of the final rules are available at: <http://www.sec.gov/rules/final/2012/33-9330.pdf>

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