



## SEC Adopts Final Rule Requiring Listing Standards for Compensation Committees

*June 29, 2012*

### INTRODUCTION

On June 20, 2012, the Securities and Exchange Commission adopted Rule 10C-1<sup>1</sup> under the Securities Exchange Act of 1934, as amended, in compliance with Section 10C thereof, which section was added to the Exchange Act pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Rule 10C-1 closely follows Section 10C and directs national securities exchanges (“exchanges”) to prohibit the listing of any equity security of an issuer that does not comply with the rules to be promulgated by the exchanges regarding, among other matters, the independence of compensation committees, the authority to retain compensation consultants and the consideration of compensation adviser independence. The SEC also amended Item 407(e)(3) of Regulation S-K to require the disclosure by issuers of any conflicts of interest of their compensation consultants.

To the extent that Rule 10C-1 contemplates the adoption by exchanges of new listing standards giving effect to the rule and the SEC has allowed flexibility to develop such listing standards, the application of Rule 10C-1 will be subject to further refinement.

Rule 10C-1 and the amendments to Item 407(e)(3) will become effective on July 27, 2012. However, exchanges will have until September 25, 2012 to propose listing standards in compliance with Rule 10C-1 and will have until June 27, 2013 to implement final rules with SEC review. Issuers must comply with the amendments to Item 407(e)(3) in any proxy 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.

### COMPENSATION COMMITTEE INDEPENDENCE

New Rule 10C-1 directs exchanges to implement new listing standards that would prohibit exchanges from listing or continuing to list equity securities of an issuer unless each member of such issuer’s compensation committee<sup>2</sup> is a member of its board of directors and is independent,

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<sup>1</sup> Final Rule: Listing Standards for Compensation Committees, Exchange Act Rel. No. 34-67220 (June 20, 2012), available at <http://www.sec.gov/rules/final/2012/33-9330.pdf>.

<sup>2</sup> For the purposes of this discussion, a compensation committee means, in the absence of a committee designated as the “compensation committee”, any committee that performs the functions of a compensation committee, including the oversight of executive compensation, or, other than with respect to the authority to retain and the funding of compensation advisers, those members of the board of directors who oversee executive compensation matters in the absence of such committees.

subject to certain exemptions discussed below. When determining independence requirements of compensation committee members, the exchanges are required to consider relevant factors, including:

- The source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by such issuer to such member of the board of directors; and
- Whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of such issuer.

In the release adopting Rule 10C-1, the SEC described additional factors exchanges could consider when determining independence requirements. For example, the SEC noted similarities between Section 10A(m) of the Exchange Act relating to audit committee independence and Section 10C(a). The SEC interpreted Section 10C as providing more discretion to the exchanges, but indicated that it expects exchanges to consider whether the audit committee independence requirements in Section 10A(m) of the Exchange Act should also apply to compensation committee members.

The SEC also emphasized in the adopting release that it is important for exchanges to consider ties between a listed issuer and a director that might impair the director's judgment as a member of the compensation committee, such as personal or business relationships between members of the compensation committee and the listed issuer's executive officers. The SEC noted, however, that the rule does not require exchanges to prohibit all affiliates from serving on compensation committees and that the rule affords exchanges discretion to define the term "affiliate" in this context or impose look-back periods relating to the independence of compensation committee members.

## COMPENSATION ADVISERS

### *Oversight*

Rule 10C-1 directs exchanges to promulgate listing standards that allow compensation committees to:

- In their sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser;
- Be directly responsible for the appointment, compensation and oversight of the work of any such adviser that is retained by the compensation committee; and
- Provide for the payment of reasonable compensation to any such adviser that is retained by the compensation committee.

Rule 10C-1 states, however, that compensation committees are not required to implement or act in conformity with the advice or recommendations of such consultants, counsel or advisers. In addition, Rule 10C-1 requires a compensation committee's authority to extend to those advisers

retained by the compensation committee but not to those advisers retained by the issuer or management.

In the adopting release, the SEC clarified that Rule 10C-1 does not require compensation committees to retain or obtain advice only from independent advisers. A listed issuer's compensation committee may retain or obtain advice from non-independent consultants, counsel or advisers, including in-house counsel or consultants, counsel or advisers retained by management.

Once listing standards have been promulgated, affected issuers should revisit their compensation committee charters to confirm that their compensation committees have the required authority to comply with the new standards.

### *Independence of Compensation Advisers*

Rule 10C-1 also directs exchanges to implement listing standards that require an issuer's compensation committee to assess the independence of each compensation consultant, legal counsel and other adviser that provides advice to the compensation committee (collectively, "compensation advisers"), other than the issuer's in-house counsel. This independence assessment must take into consideration the following six factors, as well as any additional factors identified by the exchange:

- The provision of other services to the issuer by the person that employs the compensation adviser;
- The amount of fees received from the issuer by the person that employs the compensation adviser, as a percentage of the total revenue of the person that employs the compensation adviser;
- The policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts of interest;
- 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 relationship of the compensation adviser or the person employing the compensation adviser with an executive officer of the issuer.

Rule 10C-1 does not include any materiality, numerical or other thresholds that would narrow the circumstances in which a compensation committee is required to consider the independence factors specified in the rule. The six independence factors enumerated above should be considered in their totality and no one factor should be viewed as a determinative factor of independence.

While Rule 10C-1 does not require a compensation adviser to be independent as noted above, the rule does require that compensation committees consider the enumerated independence

factors before selecting a compensation adviser. Accordingly, compensation committees should consider adding the enumerated independence factors to their meeting agendas for consideration before hiring or obtaining advice from a compensation adviser. Additionally, compensation committees are required to consider the independence of each compensation adviser that provides advice to it, even those retained by management or by the issuer. The SEC noted, however, that Rule 10C-1 does not require a listed issuer to describe its compensation committee's process for selecting compensation advisers pursuant these considerations.

### *Conflict of Interest Disclosure*

The SEC also adopted amendments to Item 407(e)(3) of Regulation S-K to require that proxy statements include conflict of interest disclosure with respect to compensation consultants. The disclosure is required in respect of any compensation consultant that had any role in determining or recommending the amount or form of executive and director compensation (subject to certain exclusions) during the issuer's last completed fiscal year whose work has raised any conflict of interest.<sup>3</sup> The disclosure must describe the nature of the conflict and how the conflict is being addressed. The instruction to new Item 407(e)(3)(iv) states that the six independence factors for compensation consultants (listed above) are among the factors that should be considered in determining whether a conflict of interest exists. Under amended Item 407(e)(3), issuers will continue to be permitted to exclude discussions of consulting services involving only broad-based, non-discriminatory plans or the provision of non-customized survey data.

It should be noted that the new amendments to Item 407(e)(3) only require disclosure of conflicts of interest with respect to compensation consultants. The new amendments do not require disclosure with respect to legal counsel or other advisers to the compensation committee.

### **EXEMPTIONS**

Rule 10C-1 also directs exchanges to exempt certain issuers from the requirements of Rule 10C-1<sup>4</sup> and permits exchanges to provide for further exemptions. Exchanges are also required to provide for appropriate procedures for a listed issuer to have a reasonable opportunity to cure any defects in such issuer's compliance with applicable Rule 10C-1-related listing standards before an exchange prohibits an equity listing pursuant to Rule 10C-1.

The following issuers are exempt from the Rule 10C-1 requirements relating to both the independence of compensation committees and the independence of compensation advisers:

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<sup>3</sup> In the adopting release, the SEC noted that this "any role" trigger is different from the trigger in Section 10C(c)(2) that, in general, requires issuers to disclose whether the compensation committee "retained or obtained the advice of a compensation consultant." The SEC explained that it will not change the "any role" trigger in the revised Item 407(e)(3) because it believes that there will be little practical difference in the application of the two disclosure triggers as they relate to consultants advising on executive compensation matters.

<sup>4</sup> Certain listed security futures products and standardized options are also exempt from the requirements of Rule 10C-1.

- Controlled companies (which is defined to mean companies with listed equity securities and of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company); and
- Smaller reporting companies.

In addition to the exemptions above, the following issuers are also exempt from the compensation committee independence requirements of Rule 10C-1:

- Limited partnerships;
- Companies in bankruptcy proceedings;
- Open-end management investment companies registered under the Investment Company Act of 1940, as amended; and
- Any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee.

The exchanges are also permitted to provide for additional exemptions from the requirements in Rule 10C-1, as the exchanges determine to be appropriate, taking into consideration the size of an issuer and other relevant factors.

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