



RADFORD ALERT

Assessing the Impact of New SEC Standards for Compensation Committee and Adviser Independence

At the end of June, the Securities and Exchange Commission (SEC) released final rules under Section 952 of the Dodd-Frank Wall Street Reform Act pertaining to Compensation Committee and compensation adviser independence. The new standards include the adoption of Rule 10C-1 under the Securities and Exchange Act of 1934 (Rule 10C-1) and amendments to Item 407 of Regulation S-K (Item 407). Together, these standards will govern the means by which Boards maintain the independence of Compensation Committees, manage potential conflicts of interests and assess the impartiality of key advisers, namely compensation consultants.

Although the new SEC rules do not represent a remarkable change of course from previously proposed regulations or behaviors already in place at most public companies, the new regulations do offer directors a greater degree of clarity on the rules of the road going forward. Looking ahead, we view these standards as a positive opportunity for Boards to formalize their approaches toward assessing independence issues in a more systematic, regular fashion.

Timing and Implementation

The ultimate implementation target for Rule 10C-1 is June 27, 2013. This date marks the deadline by which exchanges in the United States must achieve final compliance with the new SEC standards. However, insights into the make-up of final listing requirements for each exchange should emerge much sooner, as the exchanges only have 90 days (ending September 25, 2012) to publish proposed listing requirements.

Given certain flexibilities in the new SEC standards, it is quite possible companies listed on the NASDAQ market may face different requirements than those listed on the NYSE or other markets. As such, Boards and Compensation Committees are strongly encouraged to continue monitoring their respective exchanges for further announcements in the coming months.

The compliance deadline for the amended version of Item 407 is less distant on the horizon: January 1, 2013. Any definitive proxy statement relating to an annual shareholder meeting on or after this date will need to include a discussion of the requirements under Item 407. With that date in mind, it certainly behooves Boards to start considering independence issues sooner rather than later. This will provide directors with more time to understand and implement new requirements along with any related company policies they choose to adopt as a result of the new SEC standards.

Board Action Items:

Prepare to make disclosures under the amended version of Item 407 of Regulation S-K in upcoming proxies, and monitor exchanges (e.g., NYSE and NASDAQ) for proposed listing standards under SEC Rule 10C-1.

Key Requirements for Compensation Committees

Under Rule 10C-1, the SEC now prohibits US exchanges from listing companies if two key conditions regarding Compensation Committee members are not met. These conditions include:

1. Compensation Committee members must be members of the full Board of Directors; and
2. Compensation Committee members must be independent (as defined under the yet to be finalized listing standards for each exchange).

Naturally, most Compensation Committees already meet these fairly straightforward requirements; however, the job of assessing committee member independence now becomes far more important than in past years.

As we note in the second bullet above, the SEC's rules do not attempt to define independence outright, and only provide exchanges with factors for developing their own final listing standards. According to the SEC, final listing rules should include consideration of:

1. 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 such director; and
2. Whether a member of the board of directors of a company is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

Board Action Items:

Start assessing the independence of Compensation Committee members against the SEC's two key factors: sources of compensation and potential company affiliations. Monitor the exchanges for further rule changes.

However, the individual exchanges are not limited to these two factors.

They may add their own independence requirements, or, pursuant to Section 10C(a)(4) of the Exchange Act, they may also "exempt particular relationships from the independence requirements, as each exchange determines is appropriate, taking into consideration the size of an issuer and any other relevant factors."

Beyond outlining basic independence standards for individual Compensation Committee members, the SEC's new standards also include remarks on the roles and responsibilities of Compensation Committees as a whole, particularly in relation to the selection of compensation advisers. To this end, Rule 10C-1 requires the exchanges to adopt listing standards codifying the following topics:

1. The Compensation Committee may, in its sole discretion, retain or obtain the advice of a compensation adviser;
2. The Compensation Committee, which for this purpose includes those members of a listed issuer's board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of a board committee, shall be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser retained by the compensation committee; and
3. Each listed issuer must provide for appropriate funding for payment of reasonable compensation, as determined by the Compensation Committee, to any compensation adviser retained by the Compensation Committee.

Board Action Items:

Consider amending Compensation Committee charters to align with the new SEC listing requirements under Rule 10C-1, if needed.

Like many of the new independence standards adopted by the SEC, the above guidelines do not serve as a serious departure from common practices already in place at many public companies. Nevertheless, the new rules do bring clarity to questions of appropriate Compensation Committee roles and boundaries, and as such, Radford recommends reviewing existing Compensation Committee charters for alignment with Rule 10C-1.

Of note, the above factors *do not* require Compensation Committees to retain the services of a compensation adviser, nor an independent adviser if one is selected at all. Additionally, they do not assign responsibility to the Compensation

Committee for advisers not retained by the Committee directly, such as compensation consultants or legal counsel retained by management. Overall, Compensation Committee discretion in these areas is preserved.

A New Model for Assessing Adviser Independence

Rule 10C-1 requires exchanges to adopt listing standards providing that a Compensation Committee may select an outside adviser, chiefly compensation consultants, only after considering the following independence factors:

1. Whether the compensation consulting company employing the compensation adviser is providing any other services to the company;
2. How much the compensation consulting company who employs the compensation adviser has received in fees from the company, as a percentage of the firm's total revenue;
3. What policies and procedures have been adopted by the compensation consulting company employing the compensation adviser to prevent conflicts of interest;
4. Whether the compensation adviser has any business or personal relationship with a member of the compensation committee;
5. Whether the compensation adviser owns any stock of the company; and
6. Whether the compensation adviser or the person employing the adviser has any business or personal relationship with an executive officer of the issuer.

Board Action Items:

Consider the adoption of a formal policy governing reviews of adviser independence. Aligning policies with SEC factors (that still provide significant room for Committee discretion) could make compliance easier.

Of critical importance, the new SEC statute “does not require a compensation adviser to be independent, only that the Compensation Committee of a listed issuer considers the enumerated independence factors before selecting a compensation adviser.” As a result, as we note in the introduction to this alert, we believe the above factors outlined by the SEC represent a positive development for Compensation Committees. They provide a clear, consistent roadmap for assessing consultant independence in a regular fashion now and in the future, while also maintaining Compensation Committee discretion to assess the relative importance of each factor as they see fit.

Going forward, we recommend Compensation Committees review the above factors (plus any additional factors introduced by relevant exchanges or deemed appropriate by the Committee) on an annual basis, or at least when considering the performance of, or retention of a compensation adviser. Committees may also want to adopt formal independence policies of their own, potentially expanding upon the factors listed above by the SEC, but more importantly defining the frequency of independence reviews and assessing the extent to which individual factors should influence Committee decisions.

The creation of a formal policy with regular review cycles will ultimately make the preparation of independence disclosures less onerous. Furthermore, this practice is already commonplace for Audit Committees when considering audit firms, and will improve overall governance and discipline within the Compensation Committee. Again, individual exchanges have discretion to adopt their own formal rules in this area, so it's possible that more factors may be added to the list or that any number of the factors listed above may become more restrictive.

Understanding Item 407 Requirements as Amended

Beyond all of the issues described above, substantial disclosure requirements under Item 407 remain in place. As such, companies should be prepared to at least maintain many of their existing disclosures related to compensation advisers. Specifically, under Item 407(e)(3)(iii), registrants will continue to be required to disclose “any role of compensation consultants in determining or recommending the amount or form of executive and director compensation.” Of note, this requirement continues to include *director* compensation, a detail which must not be overlooked. For companies with an adviser making recommendations on executive and/or director compensation, the following information is required:

1. Identify the consultants;
2. State whether such consultants were engaged directly by the Compensation Committee or any other person;
3. Describe the nature and scope of the consultant's assignment and the material elements of any instructions given to the consultants under the engagement; and
4. Disclose the aggregate fees paid to a consultant for advice or recommendations on the amount or form of executive and director compensation and the aggregate fees for additional services if the consultant provided both and the fees for the additional services if they have exceeded \$120,000 during the fiscal year.

Board Action Items:

Start working with existing advisers to review potential conflicts of interest.

In addition to the above requirements, Item 407(e)(3)(iv) now includes a disclosure requirement regarding conflicts of interest whenever a consultant is involved in determining executive and/or director compensation. Specifically, issuers are required to provide related disclosures describing any conflicts of interest *raised* by the consultant's work, and how such conflicts are being addressed. (For this purpose the

six independence factors mentioned above must be considered.) Importantly, the SEC decided to use an "*any role*" trigger for conflict of interest disclosures. This means the conflict of interest requirement applies to "any compensation consultant whose work must be disclosed pursuant to the Item 407(e)(3)(iii), regardless of whether the compensation consultant was retained by management or the Compensation Committee or any other board committee." Whether or not specific conflicts are identified, Compensation Committees will likely benefit from disclosing that potential conflicts of interest are considered and reviewed at appropriate times.

Finally the SEC stated, "consulting on broad-based plans and providing non-customized benchmark data will continue to be exempted from the compensation consultant disclosure requirements under Item 407(e)(3)(iii), including the new conflicts of interest disclosure required in our rules implementing Section 10C(c)(2)."

Key Exemptions

Five categories of issuers are excluded from the Compensation Committee member independence requirements under Rule 10C-1. These issuers include: "controlled companies, limited partnerships, companies in bankruptcy proceedings, open-end management investment companies registered under the Investment Company Act of 1940 (the "Investment Company Act"), and foreign private issuers that disclose in their annual reports the reasons why they do not have an independent compensation committee."

Next Steps

The SEC's release of final independence standards under Section 952 of the Dodd-Frank Wall Street Reform Act brings to a close one of the most anticipated compensation-related rulemaking efforts under the landmark piece of legislation. However, several outstanding issues remain, which boards must continue to monitor in the coming months. First and foremost, each US exchange will soon adopt their own specific listing requirements based on the SEC's standards. These requirements may differ from exchange to exchange and could also add additional compliance hurdles into the mix. Next, boards must define policies for assessing the independence of Compensation Committee members, followed by decisions on the extent to which they should formalize independence policies for compensation advisors. With a January 1, 2013 deadline looming for some elements of the new law, these are all issues directors will need to consider over the next few months.

About the Authors

To contact the authors of this article, please write to Linda E. Amuso at lamuso@radford.com, Ed Speidel at espeidel@radford.com, Ram Kumar at rkumar@radford.com or Alex Cwirko-Godycki at acwirko@radford.com. Linda and Alex are based in San Francisco. Ed is based in Boston and Ram is based in New York.

Contact Us

For more information, please contact:

Boston Office

Ed Speidel, Partner

+1 (508) 628-1552

espeidel@radford.com

Ted Buyniski, Partner

+1 (508) 628-1553

tbyniski@radford.com

Rob Surdel, Associate Partner

+1 (508) 628-1551

rsurdel@radford.com

New York Office

Ram Kumar, Director

+1 (212) 441-2007

rkumar@radford.com

San Diego Office

Ken Wechsler, Director

+1 (858) 755-8675

ken.wechsler@radford.com

San Francisco Office

Linda E. Amuso, President

+1 (415) 486-7255

lamuso@radford.com

David Knopping, Partner

+1 (415) 486-7122

dknopping@radford.com

San Jose Office

Brett Harsen, Associate Partner

+1 (408) 321-2547

bharsen@radford.com

Press Contact

Alex Cwirko-Godycki

+1 (415) 486-6973

acwirko@radford.com

Locations

Bangalore, Beijing, Boston, Brussels, Chicago, Frankfurt, Hong Kong, London, New York, Philadelphia, San Francisco, Shanghai and Singapore

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