June 22, 2012

SEC Issues Dodd-Frank Compensation Committee Rules

The Securities and Exchange Commission (SEC) issued final Rule 10C-1 [1] on Wednesday, directing securities exchanges to adopt rules requiring compliance with:

- compensation committee member independence standards and
- rules requiring a review of the independence of certain compensation advisers retained by a compensation committee as conditions to the listing of an issuer's equity securities. [2]

The SEC has required that the new rules be made applicable to any committee of the board that performs functions typically performed by a compensation committee, including oversight of executive compensation, whether or not such committee also performs other functions or is formally designated as a compensation committee. [3] As discussed below, the SEC simultaneously issued revisions to Item 407 of Regulation S-K with new proxy disclosure requirements related to conflicts of interest in respect of compensation consultants. While largely following the rules proposed in March 2011, the final Rule contains some important clarifications. The Rule makes clear that a listed issuer's compensation committee need not be the entity retaining those who provide the committee with compensation advice and such advisers need not be independent. However, the Rule makes clear that the committee nonetheless will be required to conduct an independence assessment, as outlined below, with respect to every compensation consultant, legal counsel or other adviser that provides advice to the compensation committee (collectively, "compensation advisers"), other than in-house legal counsel, before receiving such advice, regardless of who retains the adviser. The independence assessment, which need not be disclosed, is to be made without any materiality, numerical or other threshold. **Compensation Committee Director Independence Requirements** New Rule 10C-1(b)(1) requires that each member of a listed issuer's compensation committee be a member of the board of directors and be independent. The Rule does not require a uniform definition of "independence." Exchanges are required to consider relevant factors, including, but not limited to:

- a director's source of compensation, including any consulting, advisory or compensatory fee paid by the issuer, and
- whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

The Rule does not specify any additional factors, nor are any standards prescribed that automatically preclude a finding of independence. Exchanges are expected to consider whether those prohibitions in the definition of "audit committee independence" also should apply to compensation committee members. However, even though affiliated directors are not allowed to serve on audit committees, the exchanges are free to determine that such a blanket prohibition is inappropriate for compensation committees and that certain affiliates, such as representatives of significant shareholders, should be permitted to serve. On the other hand, the exchanges may conclude that personal or business relationships between members of the compensation committee and the listed issuer's executive officers should be addressed in the definition of "independence." **Authority to Retain Compensation Advisers, Responsibilities and Funding** The statute provides that a compensation committee is to be directly responsible for the appointment, compensation and oversight of the work of compensation consultants, including independent legal counsel and other advisers, it chooses to retain. The Rule reiterates that this authority is not to be construed to require the compensation committee to implement or act consistently with the advice or recommendations of a compensation adviser or to affect the ability or obligation of the compensation committee to exercise its own judgment in fulfillment of its duties. The Rule does not require compensation committees to retain or obtain advice only from independent advisers, and the Rule clarifies that the scope of the requirement is *limited to only those compensation advisers retained by the compensation committee (though the independence assessment discussed below will apply to all advisers to the committee).*

- Compensation committee directors may receive advice from nonindependent counsel, such as internal counsel or outside counsel retained by management, or from a nonindependent compensation consultant or other adviser, including those engaged by management.
- The Rule does not require a compensation committee to be directly responsible for the appointment, compensation or oversight of such compensation advisers that are not retained by the compensation committee, such as compensation consultants or legal counsel retained by management.
- The statute requires the issuer to provide appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any compensation advisers to the committee, regardless of their independence.

Compensation Adviser Independence Factors The Exchange Act requires that the selection of a compensation adviser by a compensation committee take place only after it considers five independence factors and any other factors identified by the SEC. Again, the statute does not require a compensation adviser to be independent, only that the committee consider the enumerated independence factors before selecting the compensation adviser. The independence factors must be competitively neutral and at minimum include:

1. the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;
2. the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;
3. the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
4. any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; and
5. any stock of the issuer owned by the compensation consultant, legal counsel or other adviser.

In the new Rule, the SEC requires that consideration of any business or personal relationships between the executive officers of the issuer and the compensation adviser or the person employing the adviser be considered as a sixth factor. This would include, for example, situations where the chief executive officer and the adviser have a familial relationship or are business partners. As with the proposed rule, the final Rule does not expand the stock ownership factor to require consideration of stock owned by the person employing a compensation adviser. The SEC notes that the six factors should be considered in their totality and that no one factor should be viewed as a determinative factor of independence, but the SEC did not consider it necessary to provide that instruction in the Rule. As noted above, a listed issuer's compensation committee is required to conduct the independence assessment with respect to any compensation consultant, legal counsel or other adviser that provides advice to the compensation committee, other than in-house legal counsel, regardless of who retains the advisor, before the advice is rendered. This obligation applies without any materiality, numerical or other threshold. Consistent with the proposed rule, the final Rule does not require issuers to describe the compensation committee's process for selecting compensation advisers pursuant to the new listing standards. **Exemptions** The Rule also implements the exemptions from some or all of the requirements provided for in Section 10C of the Exchange Act:

- Final Rule 10C-1(b)(1)(iii)(A) exempts issuers in four of five specified categories: limited partnerships, companies in bankruptcy proceedings, open-end management investment companies registered under 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.
- Final Rule 10C-1(b)(1)(iii)(B) implements Section 10C(a)(4), permitting exemption of particular relationships from the independence requirements, taking into consideration the size of the issuer and any other relevant factors.
- Final Rule 10C-1(b)(5)(i) implements Section 10C(f)(3), providing authorization to exempt any category of issuer for smaller reporting issuers.

- Final Rule 10C-1(b)(5)(ii) exempts controlled companies from all the requirements of Section 10C and eliminates the requirement of director elections previously provided for in the proposed rule. Controlled companies are defined as listed companies in which more than 50 percent of the voting power for the election of directors is held by an individual, a group or another company.

The Rule permits relaxed rules for smaller companies, in recognition of the fact that the executive compensation arrangements of small-business issuers generally are much less complex and do not warrant the more extensive disclosure requirements and related regulatory burdens. **Compensation Consultant Disclosure and Conflicts of Interest** In proxy or consent solicitation material for its annual meeting, an issuer must disclose (A) if the compensation committee has retained or obtained the advice of a compensation consultant and (B) if the work of the 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 is adopting amendments to Item 407 of Regulation S-K to address the required disclosures rather than integrating them with the compensation consultant disclosure provisions, as originally proposed. *Retention of Compensation Consultants.* 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." Specifically, registrants will continue to be required to:

- identify the consultants;
- state whether such consultants were engaged directly by the compensation committee or any other person;
- describe the nature and scope of the consultant's assignment and the material elements of any instructions given to the consultant under the engagement; and
- 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 exceeded $120,000 during the fiscal year.

The Rule will continue not to require fee disclosure for compensation consultants that work with management if the compensation committee has retained a separate compensation consultant. *Disclosure of Conflicts of Interest.* Disclosure of compensation consultant conflicts of interest is addressed in new Item 407(e)(3)(iv). For this purpose, a compensation consultant playing "any role" triggers disclosure, regardless of how the compensation consultant was "retained" or how the compensation committee "obtained" the advice. Thus, the new requirement applies to any compensation consultant whose work must be disclosed pursuant to Item 407(e)(3)(iii), regardless of whether the compensation consultant was retained by management, the compensation committee or any other board committee. The new provisions apply to issuers subject to the proxy rules, including controlled companies, nonlisted issuers and smaller reporting companies, even though not mandated by Exchange Act Section 10C. Foreign private issuers that are not subject to the proxy rules will not be required to provide this disclosure. The final amendments will include an instruction to Item 407(e)(3) noting that, in deciding whether there is a conflict of interest that may need to be disclosed, issuers should, at a minimum, consider the six factors outlined above. The final rule will not require disclosure of potential conflicts of interest or an appearance of a conflict of interest, nor will it require disclosure with respect to compensation advisers other than compensation consultants. Consulting on broad-based plans and providing noncustomized benchmark data will continue to be exempted from the compensation consultant disclosure requirements under Item 407(e)(3), including the new conflicts-of-interest disclosure required in the rules implementing Section 10C(c)(2). The existing disclosure trigger in Item 407(e)(3), which requires disclosure of the role played by compensation consultants in determining or recommending executive and director compensation, is retained. **Timetable** The Rule requires that each national securities exchange and national securities association provide the SEC within 90 days of publication of the Rule in the *Federal Register* proposed rules that comply with new Rule 10C-1 and final SEC-approved rules within one year of such publication. Issuers must comply with the conflict-of-interest disclosure changes in Item 407 of Regulation S-K in any proxy or information 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. A copy of the final Rule and the SEC's release can be found at http://www.sec.gov/rules/final/2012/33-9330.pdf.

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[1] Rule 10C-1 under Section 10C of the Securities Exchange Act of 1934, enacted as Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. [2] The Exchange Act requires a reasonable opportunity to cure any

defects that would be the basis for prohibiting the listing of an issuer's securities for failure to meet the new requirements before imposition of such prohibition, and the final Rule so directs and suggests possible approaches. [3] The Rule defines the term "compensation committee" to include, for all purposes other than the requirements relating to the authority to retain compensation advisers and required funding for payment of such advisers, the members of the board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of a formal committee. In part as a result of this definition, the final Rule does not require that an issuer have a formal compensation committee. The listing standards relating to the authority to retain compensation advisers (and requiring related funding) do not extend to directors who oversee executive compensation matters outside of the structure of a formal board committee.