

## SEC Adopts Final Rules on Compensation Committee Listing Standards and Consultant Conflicts of Interest

On June 20, the SEC adopted final rules implementing the provisions of Section 952 of the Dodd-Frank Act relating to compensation committee independence, the use of compensation advisers and conflicts of interest. The rules become effective 30 days after publication in the Federal Register, although, as discussed below, the listing standards require rulemaking by NYSE and Nasdaq.

Most of the final rule takes the form of a direction to the exchanges to modify their listing standards. The exchanges will be required to propose the standards no later than 90 days after publication of the final rule in the Federal Register, and final listing standards must be in place within one year. The required disclosure about conflicts of interest, on the other hand, is implemented through an amendment to Regulation S-K and will be in effect for annual meetings held after January 1, 2013.

### Listing Standards

**Compensation Committee Independence.** Section 952 requires the SEC to direct the national securities exchanges to adopt rules prohibiting the listing of companies that do not have independent compensation committee members. In determining independence, the exchanges are to consider the sources of compensation of a committee member, including any consulting or advisory fees paid by the issuer, and whether the committee member is an affiliate of the issuer.

The final rule does not stray far from the statute in setting forth the compensation committee independence standards the exchanges must consider. Several points are worth noting:

- The final rule applies only to issuers that have listed equity securities
- The independence requirements will apply to directors who make compensation decisions where there is no separate compensation committee
- The final rule does not specify additional factors beyond those specified in the statute – compensatory arrangements and affiliate status – that the exchanges should consider in defining independence, although in the release the SEC
  - reiterated the belief it expressed in the proposing release that significant stockholdings should not necessarily disqualify someone from serving on a compensation committee
  - “emphasized” that the exchanges should consider ties between a compensation committee member and management in assessing independence.

The rules do not apply to controlled companies, limited partnerships, companies in bankruptcy, open-end investment companies or foreign private issuers that disclose in their annual reports the reasons they do not have an independent compensation committee.

**Authority to Retain Compensation Advisers, Oversight and Funding.** Dodd-Frank requires that a compensation committee of a listed issuer have the authority to retain compensation consultants, independent legal counsel and other advisers and that it be responsible for the appointment and oversight of such advisers. Listed issuers are also required to provide “appropriate funding” to the compensation

committee for payment of “reasonable compensation” to advisers. These provisions are rather unremarkable and some or all of them are already found in many compensation committee charters.

**Compensation Adviser Independence.** Dodd-Frank requires that the compensation committee of a listed issuer consider independence factors in selecting its advisers. The statute sets forth five factors that a committee must consider:

- The provision by the adviser of other services to the issuer
- Fees received from the issuer as a percentage of the adviser’s total revenue
- Policies and procedures of the adviser designed to prevent conflicts
- The adviser’s business or personal relationships with members of the compensation committee
- Stock of the issuer owned by the adviser

The compensation committee is not required to retain, or seek advice from, only independent advisers. A compensation committee may retain advisers with conflicts; the committee simply must consider independence factors when making retention decisions. This determination must be made by all of the independent directors who make compensation decisions if there is no compensation committee.

The final rule tracks the five statutory independence requirements and adds a sixth. Committees will have to consider, in addition to business or personal relationships with the members of the compensation committee, any such relationships advisers have with executive officers of the issuer.

This consideration applies to **any** adviser to the compensation committee, whether or not independent, other than in-house legal counsel. Thus, for example, if the issuer’s regular outside counsel provides advice to the compensation committee, the committee must consider outside counsel’s independence based on the six factors enumerated in the rule. The same would be true if the compensation consultant engaged by management provided advice to the committee. The line between when advice is provided to management and when it is provided to the committee may not always be clear.

The release makes clear that the “stock ownership” assessment will apply to the individuals at a firm who actually provide the advice, not to the entire firm. By contrast, the other services, fees and business and personal relationship analyses must be undertaken firm-wide.

Except for disclosure of conflicts for compensation consultants discussed below, the rules do not require any specific disclosure of the results of the independence consideration or the process by which it is undertaken. However, based on our experience with compensation risk assessments, one can imagine an SEC staff comment on a proxy statement asking whether the compensation committee received the advice of any person or firm other than in-house counsel to the issuer and, if so, what process it employed to assess independence. Compensation committees who obtain such advice should consider using an “independence checklist” to be able to demonstrate that they met the applicable requirements.

**Opportunity to Cure Defects.** The final rule states that the exchange standards may provide that, if a compensation committee member ceases to be independent for reasons outside the member’s reasonable control, the individual may remain on the committee until the earlier of the next annual meeting or one year after the event. This provision is patterned after a similar cure provision for audit committees.

**Exemptions from the Listing Standards.** As noted above, Dodd-Frank exempts from the compensation committee independence requirements controlled companies, limited partnerships, companies in bankruptcy, open-end investment companies and certain foreign private issuers. Consistent with the statute, the final rule allows the exchanges to exempt particular categories of relationships from the independence requirements and to exempt additional categories of issuers (such as newly listed issuers) from the applicable listing standards altogether.

The statute itself exempts controlled companies from all of the listing standards. In the final rule, the SEC also provided a complete exemption for smaller reporting companies. Although smaller reporting companies will still have to evaluate their directors using the general independence requirements of the listing standards, and thus there may not have been any significant additional burden in assessing additional independence standards, the SEC recognized that the process of assessing adviser independence could be more time-consuming and costly.

### Compensation Consultant Disclosure and Conflicts of Interest

Item 407(e)(3) of Regulation S-K currently requires companies to disclose any role compensation consultants had in determining or recommending executive or director compensation. The item excludes disclosure about advice on broad-based plans or non-customized survey data. Dodd-Frank requires the SEC to adopt rules providing for disclosure, in proxy or consent materials for an annual meeting, of whether a compensation committee retained or obtained the advice of a compensation consultant, whether the work raised any conflict of interest and, if so, how it was addressed.

The final rule integrates the new conflict disclosure requirement with the existing requirements to disclose “any role” a compensation consultant played in determining compensation. The SEC elected not to use the “retained or obtained the advice of” language of Dodd-Frank in favor of the “any role” language in existing Item 407(e)(3). Thus, the conflict disclosure will be required about a compensation consultant that management engaged, if that consultant had any role in determining or recommending compensation. The SEC has added an instruction to Item 407 to the effect that in determining whether a consultant’s work raised any conflict of interest, the six independence factors described above for advisers “are among” the factors that should be considered.

The conflict of interest disclosure applies only to compensation consultants and not to other advisers, such as outside counsel, that may play a role in the committee’s determinations.

The conflict of interest disclosure will be in effect for annual meetings after January 1, 2013.

### What to do now?

The compensation consultant conflict disclosure will be in effect for next proxy season. And even though the listing standards will not be in effect for some time, the following are some issues that companies should be thinking about – and doing – to prepare.

- **Independence.** Make sure that no compensation committee member is receiving any compensatory payments (other than standard director compensation) – even below the threshold that would currently be permitted without disqualifying the member’s independence. If these payments will continue, companies should make plans to find a replacement on the compensation committee.

There is not much that can be done presently on the stockholdings/affiliate aspect of independence, other than to hope that the exchanges take the enlightened view the SEC expressed that significant stockholdings should not, on its own, be a disqualification.

- **Compensation Adviser Independence Factors.** The SEC has made clear that companies will have to consider the adviser conflict factors set forth in the listing standards when making their compensation consultant conflict disclosure in the proxy statement. So, even though the listing standards may not be in effect for next proxy season, the independence factors will need to be considered if a compensation consultant played any role in determining or recommending compensation. Companies, at a minimum, should use an independence questionnaire for compensation consultants, using the six factors set forth in the final rule. It will likely also make sense to gather this information for all advisers on compensation matters.
- **Compensation Committee Charters.** Review the charter of the compensation committee to see whether it has all of the provisions that the listing standards as proposed by the SEC would require. Although things may change with the final adoption of these listing standards by the exchanges, it will help to have identified any changes that will need to be made. If it looks as if an amendment to the charter will be necessary, it may make sense to wait for more clarity on the final listing standards, although they are unlikely to diverge too sharply from the SEC's final rule.

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