

SEC Adopts Dodd-Frank Compensation Committee Rules

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Rules require new listing standards regarding independence of compensation committee members and their advisers

On June 20, 2012 the SEC issued final rules, mandated by the Dodd-Frank Act, dealing with compensation committees and compensation consultants. As contemplated by the Dodd-Frank Act, some of the new provisions require the stock exchanges to adopt new listing standards (added as new Exchange Act Rule 10C-1) and others are new disclosure requirements under the proxy rules (added to Item 407(e) of Regulation S-K).

Timing. The exchanges are required to file proposed changes in their listing standards to comply with these rules no later than 90 days after the final SEC rules are published in the Federal Register, and are required to adopt final listing standards no later than one year after the SEC rules are published. The new disclosure rule applies to any proxy or information statement for an annual meeting of shareholders occurring on or after January 1, 2013.

Requirements Implemented through Exchange Listing Standards

Scope of Requirement. The new listing standards apply only to companies that have equity securities listed on a U.S. securities exchange, and do not apply to controlled companies (defined as companies where more than 50% of the voting power is held by a single individual, group, or issuer) and smaller reporting companies.

The portion of these listing standards dealing with compensation committee member independence also does not apply to limited partnerships, companies in bankruptcy proceedings, open-end management investment companies registered under the Investment Company Act of 1940, and any foreign private issuer that discloses in its annual report its reasons for not having an independent compensation committee. In addition to these categories of companies, the exchanges have flexibility to exempt particular relationships from the independence requirement and to exempt particular categories of issuers from the entire listing standard.

Comment: Foreign private issuers listed on a U.S. exchange that do have independent compensation committees would be subject to the compensation committee independence standard, and all foreign private issuers would be subject to the remaining portions of the listing standard, unless the exchange on which they are listed adopts an exemption for them.

Definition of Compensation Committee. While the final rules do not require listed companies to have a compensation committee, the requirements applicable to compensation committees will also apply to the directors performing compensation-setting functions in the absence of a formal committee (as well as to any committee making compensation decisions that is not officially called a compensation committee). This e-Alert uses the term "compensation committee" to apply to all of these categories of directors.

Comment: Because the independence rules will now apply to all directors who set executive compensation in the absence of a formal committee, listed companies that do not have a formal compensation committee may wish to establish one in order to limit the number of directors subject

to the enhanced compensation committee independence standards.

Independence of Committee Members. All members of a compensation committee (as defined above) must be members of the company's board of directors and must be independent. Each stock exchange is required to develop and adopt its own definition of independence for this purpose, subject to SEC approval. As required by the Dodd-Frank Act, the stock exchanges are required to consider the following factors, along with other factors they deem relevant, in determining their definition:

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

Comment: These are the same factors that are used in determining independence of audit committee members, as required under the Sarbanes-Oxley Act. However, in the case of audit committee members, the Sarbanes-Oxley Act requires that acceptance of compensation (other than for director service) or the existence of an affiliate relationship disqualifies a director from committee membership, whereas in the case of compensation committees the Dodd-Frank Act provides that these are merely factors to be considered by the exchange in setting independence standards.

The SEC Release adopting the final rule confirms that the exchanges may determine that the audit committee disqualification factors are not appropriate for compensation committees. Indeed, a stock exchange may well determine that it is desirable for representatives of significant shareholders to determine executive compensation. However, the Release also expressly states that the exchanges should consider whether other factors might impair a director's judgment as a member of a compensation committee, such as whether the director has a personal or business relationship with the issuer's executive officers.

Each exchange must file its proposed definition of independence for compensation committee members as a proposed rule change, which will be subject to SEC approval. The filing is required to include a discussion of the exchange's consideration of factors relevant to compensation committee independence and of how the proposed independence standard satisfies the requirements of the SEC rule.

Authority to Engage Consultants and Counsel. As required by the Dodd-Frank Act, the SEC final rule provides that each exchange must include the following requirements in its listing standards:

- The compensation committee must have the ability, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, or other adviser (collectively, "compensation advisers").
- The compensation committee must be directly responsible for the appointment, compensation, and oversight of the work of any compensation adviser that it retains.
- The issuer must provide adequate funding, as determined by the compensation committee, for payment of reasonable compensation to compensation advisers retained by the committee.

Comment: The SEC Release points out that, although compensation committees must be provided with the authority to retain independent compensation advisers, the committee is not prohibited from using the company's in-house or outside counsel or a compensation consultant retained by management.

Comment: Consistent with the Dodd-Frank Act, the rules expressly provide that the committee is not required to follow the advice or recommendation of its compensation adviser, and that any such advice or recommendation does not affect the committee's ability or obligation to exercise its own judgment in its compensation decisions.

Consideration of Compensation Adviser Independence. The Dodd-Frank Act calls for listing

standards that require a compensation committee to select a compensation consultant, legal counsel, or other adviser only after taking into consideration certain independence factors identified by the SEC (including certain factors enumerated in the Act). The SEC rule restates the factors set forth in the Act and adds one additional factor. The rule authorizes, but does not require, the exchanges to add additional factors in their listing standards. The independence factors for compensation advisers set forth in the SEC rule are as follows:

- The provision of other services to the issuer by the person that employs the compensation adviser (the "consulting entity").
- The amount of fees received from the issuer by the consulting entity as a percentage of its total revenue.
- The policies and procedures of the consulting entity that are designed to prevent conflicts of interest.
- Any business or personal relationship of the individual compensation adviser with a member of the compensation committee.
- Any stock of the issuer owned by the individual compensation adviser. The SEC Release indicates that this requires consideration of the shares owned by the individuals providing services to the compensation committee and their immediate family members.
- Any business or personal relationship of the individual compensation adviser or the consulting entity with an executive officer of the issuer.

The SEC Release contemplates that the exchanges will adopt the above factors without any bright-line thresholds or cut-offs. However, if the exchanges add other factors, those additional factors could be made subject to thresholds or cut-offs. The Release states that the above factors should be considered in their totality, with no single factor being determinative.

The committee must consider the independence of all compensation consultants, legal counsel, and other advisers they consult with — including those retained by management — with the sole exception of in-house counsel.

The Release confirms that while the compensation committee is required to take the "independence" factors into consideration when choosing a consultant, legal counsel, or adviser, there is no requirement that the consultant or other adviser selected by the committee qualify as independent.

Opportunity to Cure. As required by the Dodd-Frank Act, the SEC rules require the stock exchanges to adopt procedures providing a listed issuer an opportunity to cure any failures to meet the compensation committee listing standards before its stock can be delisted. Consistent with the treatment of audit committees, the rules expressly permit the exchanges to have a relatively long cure period where a compensation committee member ceases to be independent for reasons outside the member's reasonable control. In such cases, the director may remain a member of the committee until the earlier of the issuer's next annual meeting or one year after the event which caused a loss of independence.

Compensation Consultant Disclosure Requirements

Scope of Requirement. The SEC rules incorporate the disclosures about compensation consultants required by the Dodd-Frank Act into the existing compensation committee disclosures required by Item 407(e) of Reg. S-K. Although the Dodd-Frank provisions are mandated only for companies with equity securities listed on an exchange, the SEC rules extend the new disclosure requirement to all companies subject to the proxy rules — including controlled companies, smaller reporting companies, and non-listed domestic issuers — as is currently the case with respect to the existing Item 407(e) requirements.

Existing Requirement. The SEC final rules retain the existing requirements of Item 407(e)(3)(iii) with respect to compensation consultants, under which the company must disclose "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation." The Item calls for the following specific disclosure:

- Identification of the consultant.
- A statement of whether the consultant was engaged directly by the compensation committee or by some other person.
- A description of the nature and scope of the consultant's assignment and the material elements of any instructions given to the consultant under the engagement.
- If in the last completed fiscal year the consultant received fees in excess of \$120,000 for services other than for providing advice or recommendations with respect to executive and director compensation, the aggregate fees paid to the consultant for (i) services with respect to executive and director compensation and (ii) other services.

New Disclosure. The new requirement added pursuant to the Dodd-Frank Act is contained in a new Item 407(e)(3)(iv). With respect to any consultant identified under Item 407(e)(3)(iii), if the consultant's work raised a conflict of interest, the proxy statement must disclose the nature of the conflict and how the conflict is being addressed. In determining whether a conflict of interest exists, the issuer is required to consider at least the six "independence factors" that the compensation committee is required to consider before consulting with a compensation adviser.

Comment: The disclosure requirements under both existing Item 407(e)(3)(iii) and new Item 407(e)(3)(iv) apply whether the consultant was retained by the compensation committee or by management.

Comment: Although the compensation committee must consider the "independence factors" before consulting with legal counsel or other advisers as well as compensation consultants, the conflict of interest disclosure in Item 407(e)(3)(iv) applies only to compensation consultants.

In a departure from the proposed rules, the SEC has decided to retain the disclosure exemption for consulting services involving only broad-based, non-discriminatory plans and the provision of survey data that the consultant has not customized for the particular issuer. These exemptions will also apply to the new conflict of interest disclosure. The SEC Release clarifies that both Item 407(e)(3)(iii) and new Item 407(e)(3)(iv) also apply to consultants who play a role in determining or recommending the amount or form of director compensation.

For more information about the SEC rules relating to compensation committees and consultants, or Hughes Hubbard's executive compensation and corporate governance practices, please contact any of the following attorneys:

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