

DODD-FRANK UPDATE: SEC ADOPTS RULES ON COMPENSATION COMMITTEE INDEPENDENCE AND COMPENSATION ADVISERS

On June 20, 2012, the Securities and Exchange Commission (the “SEC”) adopted [new rules](#) affecting the composition and powers of compensation committees of listed companies and requiring new disclosure regarding compensation consultants’ conflicts of interest. These rules, proposed in March 2011, were adopted under Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

OVERVIEW

Newly adopted Rule 10C-1 under the Securities Exchange Act of 1934 (the “Exchange Act”) will require the national securities exchanges to establish listing standards requiring that each member of a listed company’s compensation committee be independent. Under the new rule, the compensation committee must also have certain authorities and duties with respect to the retention of advisers. If a listed company’s board does not have a committee responsible for executive compensation matters, the new listing standards will nevertheless apply to those members of the board who oversee executive compensation matters on behalf of the board.¹

The SEC also amended Item 407 of Regulation S-K to require proxy statement disclosures regarding conflicts of interest of compensation consultants.

COMPENSATION COMMITTEE INDEPENDENCE

New Rule 10C-1 requires each national securities exchange to establish listing standards requiring that each member of a listed issuer’s compensation committee be independent.

Under the new listing standards, “independence” is to be defined by the exchanges after taking into consideration relevant factors, which must include:

- the source of compensation of each director; and
- whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary.

While the exchanges must consider whether these factors should be used to define “independence” for compensation committee members, the exchanges are not required to include them in their definition, and the exchanges may use additional or other factors. This gives the exchanges greater discretion in determining an appropriate independence definition than afforded by Rule 10A-3 under the Exchange Act with respect to members of the audit committee, which flatly prohibits all affiliates from serving on the audit committee. Thus, for example, the exchanges are not required to prohibit directors affiliated

¹ If the listed company’s board does not have a separately designated compensation committee, the new listing standards will apply to any committee of the board that performs functions typically performed by a compensation committee.

with significant investors, such as venture capital funds or private equity funds, from serving on the compensation committee. The term “affiliate” is not separately defined for purposes of the rule.

In not adopting a uniform definition of independence, the SEC noted in its release that most exchanges already require that directors who compose a compensation committee, or in the absence of such a committee, directors who determine executive compensation matters, be “independent” under an exchange-defined independence test. The SEC also said that exchanges need flexibility to develop requirements that are appropriate for a wide variety of issuers.²

THE COMPENSATION COMMITTEE AND ADVISERS

Under new Rule 10C-1, national securities exchanges must establish listing standards providing that the compensation committee of any listed company may, in its sole discretion, retain a compensation adviser, legal consultant or other adviser, and that the compensation committee will be directly responsible for the appointment, compensation and oversight of any such adviser. The issuer must also provide the compensation committee with appropriate funding for payment to advisers retained by the committee.

The exchange listing standards must also provide that the compensation committee may only select a compensation consultant, legal counsel or other adviser after considering the following independence factors:

- whether the firm employing the adviser provides other services to the issuer;
- the amount of fees received from the issuer by the firm that employs the adviser, as a percentage of that firm’s total revenue;
- the policies and procedures adopted by the firm employing the adviser to prevent conflicts of interest;
- whether the adviser has any business or personal relationship with a member of the compensation committee;
- whether the adviser owns any stock in the issuer; and
- whether the adviser or firm employing the adviser has any business or personal relationship with an executive officer of the issuer (the SEC added this factor in the final rule in response to comments on the proposed factors).

While the new listing standards almost certainly will create a presumption that compensation committees should normally receive advice only from independent advisers, it is important to note that the listing standards will merely require the compensation committee to consider the independence factors listed above. The SEC’s adopting release makes clear that the compensation committee will not be precluded from retaining or receiving advice from an adviser who is not independent. Nor does the rule preclude the use of advisers not retained by the compensation committee. The SEC also noted that a listed company’s compensation committee should consider the independence factors in their totality and that no single factor should be determinative. Finally, the final rule contains an instruction clarifying that this independence analysis will not be required for in-house counsel.

EXEMPTIONS

None of the new listing standards will apply to controlled companies, and the exchanges will have discretion to exempt other categories of issuers from the new listing standards. In addition, although

² In addition to existing listing requirements, directors who oversee executive compensation matters may also already be required to meet independence standards for purposes of short-swing profit liability exemption under Section 16(b) of the Exchange Act and compliance under Section 162(m) of the Internal Revenue Code.

not required by the Dodd-Frank Act, the SEC opted to exempt smaller reporting companies from all of the new listing standards in response to comments received on the proposed rule.

Further, the portion of the listing standards requiring compensation committee members to be independent will not apply to limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies or foreign private issuers, if the foreign private issuer discloses in its annual report the reasons why it does not have an independent compensation committee. The exchanges may also exempt particular relationships from these independence requirements.

CONFLICT OF INTEREST DISCLOSURE

As revised, Item 407(e)(3) of Regulation S-K will now require disclosure of any actual conflicts of interest resulting from the work of any compensation consultant required to be disclosed under such Item (this would include compensation consultants retained by the committee or by management).³ This rule, in contrast to the listing standards relating to advisers discussed above, only applies to *compensation consultants*, and does not require disclosure of conflicts of interest of legal counsel or other advisers. Although the SEC considered extending the disclosure requirement to such other advisers, the Dodd-Frank Act does not mandate such disclosure and the SEC determined that the potential benefit to investors of the additional disclosure did not justify the additional burden of providing it.

In determining whether a disclosable conflict of interest exists, the new rule directs companies to consider the six independence factors described above (i.e., those to be used by the compensation committee when evaluating a compensation adviser's independence). Where the work of a compensation consultant has raised a conflict of interest, the company must disclose how the conflict was addressed. Disclosure is not required, however, for potential conflicts of interest or an appearance of a conflict of interest.

It will be interesting to see how companies that use a single compensation consultant to provide advice to both management and the compensation committee approach this new disclosure requirement, particularly the requirement to assess whether an actual conflict exists, and to disclose how the conflict of interest is being addressed. As a practical matter, this new disclosure obligation could drive some companies currently using a single consultant for both management and the committee to cease such practice.

IMPLEMENTATION TIMELINE

The exchanges will have 90 days from publication of new Rule 10C-1 in the Federal Register to submit proposed listing standards to the SEC, and such listing standards must be approved by the SEC within one year of such date.

Issuers must comply with the amended Item 407(e)(3) disclosure in any proxy statement for an annual meeting of shareholders at which directors will be elected occurring on or after January 1, 2013.

NEXT STEPS FOR COMPANIES TO CONSIDER

Although it may be premature to take action until the exchanges adopt (or amend) their listing standards in accordance with Rule 10C-1, there are a number of action items for companies and compensation committees to start thinking about.

³ Item 407(e)(3) of Regulation S-K exempts certain consulting services from disclosure, and those consulting services would similarly be exempt from the new conflicts of interest disclosure. These include services (i) relating to broad-based plans that do not discriminate in favor of executives or directors, (ii) that do not provide customized information for a particular company, or (iii) that are customized, but not based on criterion set by the compensation consultant, if no related advice is provided by the compensation consultant.

- **Compensation Committee Charter:** the charter for the compensation committee should be reviewed to determine whether revisions are needed to address the independence requirement for members of the committee, for example, by referring to the new or amended sections of the applicable listing standards. In addition, the charter should be reviewed to ensure that it provides the committee with the appropriate authorities and powers contemplated by the new listing standards, as well as requiring the committee to undertake the independence analysis for advisers contemplated by Rule 10C-1.
- **Procedures for Determining Independence of Committee Members:** existing policies and procedures regarding the Board's determination of the independence of compensation committee members will likely need to be revised so that they reflect the Board's consideration of the factors set forth in Rule 10C-1 and/or any different or other factors identified by the exchanges in their listing standards.
- **D&O Questionnaires:** Director and officer questionnaires used to prepare the annual proxy statement and annual report will need to be revised to include, for members of the compensation committee, questions responsive to the independence criteria in the new listing standards.
- **Procedures for Evaluating Independence of Advisers to Committee:** the compensation committee's policies and procedures for retaining or obtaining advice from advisers will need to be reviewed and revised as necessary to ensure that the committee undertakes a review of the independence of such advisers before retaining them or, in the case of advisers already engaged by management on behalf of the company, obtaining advice from them. These procedures will need to incorporate consideration of the six independence factors set forth in Rule 10C-1 and any other factors identified by the exchanges. It may be prudent to request such advisers to complete a questionnaire to elicit the information needed by the committee to conduct its independence evaluation, and the committee's procedures should ensure that its process is appropriately documented.
- **Procedures for Evaluating Conflicts of Interest of Compensation Consultants:** policies and procedures may need to be established or updated for evaluating conflicts of interest raised by the work of compensation consultants providing services to the compensation committee. These procedures will need to incorporate consideration of the six independence factors set forth in Rule 10C-1.

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