

ClientAlert

Financial Markets Developments

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SEC Issues Compensation Committee and Compensation Consultant Independence Rules as Required by the Dodd-Frank Act

On June 20, 2012, the Securities and Exchange Commission (the "SEC") published final rules (the "Compensation Rules") requiring securities exchanges to change their listing standards with respect to compensation committee independence and authority, and requiring additional proxy statement disclosures regarding compensation consultants. The Compensation Rules implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") as follows:

Requirement	Effectiveness
New Rule 10C-1 under the Exchange Act of 1934 directs US securities exchanges to adopt listing standards requiring listed companies' compensation committees (1) to solely comprise independent directors based on consideration of certain factors, and (2) to have the authority to retain, oversee and pay compensation advisers, and to consider certain factors regarding the independence of the compensation advisers.	Securities exchanges must publish proposed amendments to their listing standards no later than September 25, 2012. Final amendments to listing standards must be effective no later than June 27, 2013. The date by which the new listing standards become effective will be contained in the applicable exchange's listing standards. However, in light of the need for time to nominate new compensation committee members, it is unlikely that the new listing standards will be effective for the 2013 proxy season even if the final rules are in place at that time.
Amendments to Item 407 under Regulation S-K require listed companies to disclose in their proxy statements for annual meetings or special meetings in lieu of annual meetings whether any compensation consultant's work raised a conflict of interest and, if so, how that conflict of interest was addressed.	Issuers must comply with the new disclosure in any proxy or information statement for an annual meeting of shareholders at which directors will be elected that is held on or after January 1, 2013.



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The Compensation Rules were initially proposed in April 2011. Rule 10C-1 was adopted substantially as proposed subject only to minor adjustments. Conversely, the SEC significantly changed its proposed amendments to Item 407(e)(3), essentially keeping the existing disclosure requirements in place and adding one incremental requirement.

The new compensation committee independence listing standards will apply to foreign private issuers¹ unless they disclose in their annual report that they have opted out of listing requirements for an independent compensation committee. Even if the members of a foreign private issuer's compensation committee are not independent, the compensation committee (or any committee that fulfills the function of such a committee) must still have authority to retain, oversee and pay compensation advisers, and must consider certain factors regarding the independence of the compensation advisers. The amended proxy disclosure requirements do not apply to foreign private issuers.

Practical initial implementation steps are set forth at the end of this Client Alert.

New Exchange Listing Standards for Compensation Committees

New Rule 10C-1 directs national securities exchanges to establish listing standards governing compensation committees and compensation committee member independence, and prohibiting the listing of any equity security of a company that is not in compliance with such listing standards. As with the requirements for audit committee membership pursuant to Section 10A(m) of the Exchange Act and Rule 10A-3 thereunder, we expect that the rules of the major exchanges—the New York Stock Exchange (“NYSE”) and the NASDAQ Stock Market (“NASDAQ”)—will be largely similar.

As a practical matter, most listed companies have a compensation committee or a committee that performs the functions of a compensation committee. Nevertheless, Rule 10C-1 does not require listed companies to have a compensation committee.

The rule provides that if a listed company has a board committee that performs the functions typically performed by a compensation committee, the Compensation Rules apply to that other committee. If a listed company does not have a compensation committee or other board committee, then the Compensation Rules apply to the members of the company's board of directors who oversee compensation matters on behalf of the board.²

Compensation Committee Composition

New Rule 10C-1 directs national securities exchanges to consider “relevant factors” when promulgating listing standards related to the independence of compensation committee members. These factors, include, but are not limited to:

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

It should be noted that, subject to limited exceptions, both the NYSE and NASDAQ already require listed companies to have a compensation committee comprising entirely directors that are independent as defined under their respective listing standards.³ As a result, the SEC has alluded to the fact that exchanges could take the position that their existing requirements largely satisfy the factors above. Unlike Section 10A(m) under the Exchange Act and Rule 10A-3 thereunder that apply to audit committee independence, the compensation committee independence factors are not outright prohibitions, but merely factors to be considered by the exchanges when promulgating their rules. Nevertheless, because the relevant factors for determining independence included in Rule 10C-1 cover the same matters as the prohibitions in Section 10A(m)'s definition of audit committee independence, the SEC expects exchanges to consider whether the audit committee prohibitions should also apply to compensation committee members. We therefore examine each of these in turn below.

1. A “foreign private issuer” is any foreign issuer other than a foreign government except for an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter: (1) more than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and (2) any of the following: (i) a majority of the executive officers or directors are United States citizens or residents; (ii) more than 50 percent of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.
2. Unlike the NYSE, NASDAQ permits independent directors constituting a majority of a listed company's independent directors to determine the compensation of the company's Chief Executive Officer and other executive officers. As a result, a compensation committee is technically not required under NASDAQ listing rules. For practical reasons, as well as a result of the requirements of Section 162(m) of the Internal Revenue Code and Rule 16b-3 under the Exchange Act, discussed below in footnote 4 to this Client Alert, almost every NASDAQ-listed company has a compensation committee or other committee that performs the functions of a compensation committee.
3. Furthermore, for domestic issuers, Rule 16b-3 under the Exchange Act exempts from short-swing profit liability certain equity grants approved by a committee consisting of solely two or more “non-employee directors” and Section 162(m) of the Internal Revenue Code maintains the tax deductibility of certain awards to most named executive officers if the performance goals for such awards are approved by a committee composed solely of two or more “outside directors.”

With respect to compensation, a director who received less than US\$120,000 in compensation during any consecutive 12-month period during the prior three fiscal years may be considered independent under current exchange listing standards with respect to compensation committee members. In implementing Rule 10C-1, it is possible that the exchanges will apply stricter compensation restrictions to compensation committee members that mirror audit committee standards. Those standards prohibit payment of even a *de minimis* amount of compensation to a director who is a member of the audit committee, although there is no look-back period. Ultimately, since it is uncommon for compensation committee members to receive any compensation other than directors' fees (which are not prohibited), the adoption of such a rule by the exchanges would likely have little impact.

The question of affiliate status is more vexed. Were the exchanges to apply an outright prohibition on compensation committee membership for representatives of listed company affiliates, this would deny significant shareholders, including private equity funds that may hold close to a majority of the shares of a company, compensation committee representation. This would fly in the face of the approach currently taken by the exchanges that ownership of a significant amount of stock does not per se impair independence. While each securities exchange must consider affiliate relationships in establishing a definition for compensation committee independence, Rule 10C-1 does not require exchanges to preclude compensation committee membership based solely on such relationships. We expect that the securities exchanges will not implement such a prohibition.

At the same time that the SEC notes a blanket prohibition on affiliates serving on the compensation committee would be inappropriate, it also states that exchanges should consider "other ties" between a director and an issuer and gives the example that "personal or business relationships between members of the compensation committee and the listed issuer's executive officers" could be addressed in the definition of independence. The NYSE's commentary to its independence test states that "[m]aterial relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others" and that "it is best that boards

making 'independence' determinations broadly consider all relevant facts and circumstances."⁴ It remains to be seen whether the securities exchanges will seek to further define particular relationships that result in lack of independence for compensation committee membership. Longstanding practice under state law, where independence determinations are required in connection with special transaction committees, is that mere social ties and even friendship are not sufficient to impair independence. We believe that the general requirement under current securities exchange listing standards to consider any relationship that impairs independence already captures this concept sufficiently.⁵

Finally, it should be noted that major proxy advisers, notably Institutional Shareholder Services Inc. ("ISS"), will recommend a vote against any compensation committee member who is an "inside director" or an "affiliated outside director" as defined by ISS.⁶ ISS's definition of affiliated outside director contains a five-year look-back with respect to certain prohibited relationships and a US\$10,000 threshold for prohibited compensatory payments. As a result, companies that comply with ISS guidelines are already subject to more stringent independence standards than exist under current securities exchange listing requirements.

Compensation Committee Advisers

Rule 10C-1 directs national securities exchanges to adopt listing standards:

- Permitting a listed company's compensation committee, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel or other advisers (referred to collectively herein as "advisers")
- Establishing the compensation committee as directly responsible for the appointment, compensation and oversight of any retained adviser
- Requiring each listed company to provide appropriate funding, as determined by the compensation committee, to fund the payment of reasonable compensation to any adviser

It is important to note that the listing standards do not *require* a compensation committee to engage any adviser or prohibit the

4. NYSE Listed Company Manual, Commentary to Section 303A.02.

5. For an example of statements on this topic under state law, see dicta in *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004). In that case, the court stated: "doubt might arise [regarding a director's independence from a director that has an interest in a transaction] because of financial ties, familial affinity, a particularly close or intimate personal or business affinity or because of evidence that in the past the relationship caused the director to act non-independently vis à vis an interested director ... Mere allegations that they move in the same business and social circles, or a characterization that they are close friends, is not enough to negate independence."

6. See ISS, 2012 Proxy Voting Summary Guidelines, <http://www.issgovernance.com/files/2012USSummaryGuidelines1312012.pdf> at 14.

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engagement of any adviser that is not independent. However, securities exchanges are required to adopt listing standards requiring the compensation committee to consider certain factors related to the independence of advisers, even though the listing standards will not prohibit committees from hiring non-independent advisers once their independence has been considered. These factors, include, but are not limited to:

- Whether the entity employing the adviser provides other services to the company
- The amount of fees received from the company by the entity employing the adviser as a percentage of the total revenue of that entity
- The policies and procedures of the entity employing the adviser designed to prevent conflicts of interest
- Any business or personal relationship between the adviser and a member of the compensation committee
- Whether the adviser owns any stock in the company
- Any business or personal relationship between the adviser or entity employing the adviser and an executive officer of the company

The SEC added the sixth factor to Rule 10C-1 based on concerns expressed by commentators that such relationships could result in a significant conflict.

An independence assessment based on the above factors is required when the compensation committee retains or obtains the advice of a compensation consultant, independent legal counsel or other adviser. However, as discussed below, proxy statement disclosure regarding potential conflicts of interest is only required with respect to compensation consultants and not legal counsel or other advisers. Furthermore, no independence assessment is required for the compensation committee to consult with in-house counsel.

The clear trend among large-cap public companies, and increasingly among mid-cap public companies, is for compensation committees to engage their own compensation consultant that does not provide services to the company or its management with respect to compensation. Conversely, only a minority of compensation committees have engaged counsel separate from the company's regular outside corporate counsel. We do not expect that the Compensation Rules, and the related proxy disclosures, will significantly impact these trends.

Exempt Companies

The following companies are exempt from Rule 10C-1:

	Compensation Committee Member Independence Requirements	Authority of Compensation Committee to Engage Independent Compensation Consultant and Other Advisers
Foreign private issuer that discloses in its annual report the reasons why it does not have an independent compensation committee	Exempt	Not exempt
Limited partnerships	Exempt	Not exempt
Companies in bankruptcy proceedings	Exempt	Not exempt
Open-end management investment companies registered under the Investment Company Act of 1940 (i.e., mutual funds)	Exempt	Not exempt
Controlled companies ⁷	Exempt	Exempt
Smaller reporting companies	Exempt	Exempt

7. A "controlled company" is a company in which more than 50 percent of the voting power is held by an individual, a group or another issuer.

Rule 10C-1 exempts foreign private issuers from the compensation committee independence requirements if the foreign private issuer has opted out of the requirement to have an independent compensation committee under the rules of a national securities exchange. It is to be expected that foreign private issuers will take advantage of this opt-out option if the final independence rules are onerous; however, if those rules substantially track existing requirements and a foreign private issuer already follows such requirements, there will be little reason for a foreign private issuer to opt out. It should be noted that foreign private issuers with a compensation committee cannot opt out of the requirement that such compensation committee have the authority to engage an independent compensation consultant and other advisers.

In addition to the above general exemptions, Rule 10C-1 allows exchanges to propose other exemptions to their listing standards concerning compensation committee member independence. The exchanges will likely use this ability to enable new issuers, companies that cease to be controlled companies and companies emerging from Chapter 11 to phase in the independent directors on their compensation committee consistent with the current 90-day/one-year timeline.

Proxy Disclosure Requirements

The SEC decided not to adopt its proposed amendments to Item 407(e)(3) of Regulation S-K and instead retained its existing disclosure requirements and added one additional requirement to satisfy Section 952 of the Dodd-Frank Act. As a result, the totality of disclosure regarding compensation consultants that issuers are required to include in their proxy statements is as follows:

Disclosure Requirement	Effectiveness
"Any role" of compensation consultants in determining or recommending the amount or form of executive and director compensation.	Existing rule
The identity of the consultants.	Existing rule
Whether the consultants were engaged directly by the compensation committee or any other person.	Existing rule
The nature and scope of the consultants' assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.	Existing rule
The aggregate fees paid to any 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 US\$120,000 during the fiscal year. ⁸	Existing rule
The nature of any conflict of interest raised by the work of any consultant and how that conflict was resolved.	New rule effective for an annual meeting of shareholders at which directors will be elected that is held on or after January 1, 2013

It should be noted that the "any role" standard under current rules, which will be retained under the new rules, is broader than the trigger in Section 952 of the Dodd-Frank Act, which was "whether a compensation consultant retained or obtained by a compensation committee provided advice." Consulting on broad-based plans and providing non-customized benchmark data will continue to be

exempted from the disclosure requirements, contrary to the proposal to eliminate this exemption in the proposed amendments to Item 407(e)(3). Finally, the disclosure rules continue to apply only to compensation consultants and not to legal or other advisers to the compensation committee that are not compensation consultants.

8. Item 407(e)(3) will continue not to require fee disclosure for compensation consultants that are retained by management if the compensation committee has retained a separate compensation consultant.

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In deciding whether a conflict of interest exists and whether any related disclosure is required, issuers are required to consider, among other things, the six conflict of interest factors the compensation committee is required to consider when engaging any adviser (as described above in this Client Alert).

The new disclosure requirement will apply to all companies subject to the SEC's proxy rules, including controlled companies, non-listed issuers and smaller reporting companies. Foreign private issuers are not subject to the SEC's proxy rules and are therefore not subject to the new disclosure requirement.

Initial Practical Implementation Steps

Companies should consider the following initial practical steps to implement the Compensation Rules:

- Since the new proxy statement disclosures are effective for the 2013 proxy season, compensation committees should provide any compensation consultant they engage with a form of questionnaire to elicit information regarding the six independence factors contained in Rule 10C-1 and referenced in the instructions to Item 407(e)(3) of Regulation S-K.
- The compensation committee should discuss with legal counsel how disclosure of any conflicts of interest will appear in next year's proxy statement. Companies that engage a compensation consultant subject to a disclosable conflict of interest should consider whether that conflict rises to such a level that they should consider engaging a different compensation consultant.
- Companies should review their compensation committee charters and start to prepare any required amendments to give the compensation committee the authority to retain, oversee and pay compensation advisers. At the same time, the charter should be amended to include the process for the compensation committee to assess the independence of any compensation advisers.

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