

SEC Finalizes Independence Rules for Compensation Committees and Advisers

Yesterday, the SEC adopted [final rules](#) to implement the Dodd-Frank Act's requirements regarding the independence of compensation committees and their advisers. For the most part, the SEC made few changes from the [proposed rules](#), which in turn hewed very closely to the requirements of the statute.

The national securities exchanges will have 90 days from the publication of the final rules in the Federal Register to propose listing standards implementing the rules and one year from that date of publication to finalize their standards. New disclosure requirements regarding compensation consultants are not subject to this exchange rulemaking process and will be effective beginning with any proxy or information statement for an annual shareholders meeting (or a special meeting in lieu of an annual meeting) at which directors will be elected occurring on or after January 1, 2013.

Compensation Committee Member Independence

The SEC requires each member of the compensation committee to be an independent member of the board of directors. For this purpose, the SEC defines the "compensation committee" as:

- a board committee designated as a compensation committee;
- in the absence of such a committee, a board committee performing functions typically performed by a compensation committee, including oversight of executive compensation, even if it is not designated as the compensation committee or also performs other functions; and
- in the absence of either such a committee, the members of the board of directors who oversee executive compensation matters on behalf of the board.

The SEC leaves to the board the ultimate determination as to the independence of compensation committee members. In addition, the final rule repeats that listed companies are not required to have a compensation committee, unless otherwise required by the applicable exchange.

It will be up to the exchanges in proposing their listing standards to determine how the following factors, along with other factors that the exchanges may add, *should be considered* in evaluating the independence of compensation committee members:

- the source of compensation of a member of the board of directors, including any consulting, advisory or other compensatory fees paid by the issuer; and
- whether a member of the board of directors has an affiliate relationship with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The SEC expressly interprets the Dodd-Frank Act to provide more discretion to the exchanges to determine the independence standards that compensation committee members are required to meet than they are provided under the Sarbanes-Oxley Act with respect to audit committee members. That said, the SEC also expressly left open the possibility that the exchanges could turn these considerations into prohibitions.

In its proposing release, the SEC queried whether a director affiliated with a significant shareholder, such as a private equity or venture capital firm, would be sufficiently independent for compensation committee purposes. In the final rule, the SEC declined to reach a conclusive view on this point and instead emphasized that the exchanges consider other ties between an issuer and a director, in addition to share ownership, that could impair the director's independence – such as personal or business relationships between compensation committee members and the issuer's executive officers.

On the issue of whether any relationships prior to a director's appointment to the compensation committee or the effectiveness of these rules should be considered (*i.e.*, "look-back"), the SEC deferred to the exchanges.

Advisers to Compensation Committees

The SEC provides that compensation committees may, in its sole discretion, retain or obtain the advice of compensation consultants and other advisers, only after taking into consideration specified independence factors, and issuers must provide funding for the retention of these advisers. Compensation committees will be directly responsible for the selection, compensation and oversight of the advisers whom they retain. To be clear, compensation committees are expressly permitted to receive advice from non-independent counsel, such as in-house counsel or outside counsel retained by management, or from a non-independent compensation consultant or other adviser, including those engaged by management.

Before selecting a compensation consultant or other adviser, the compensation committee must take into consideration the following factors, as well as any other factors identified by the exchanges:

- the provision of other services to the issuer by the entity that employs the adviser;
- the amount of fees received from the issuer by the entity that employs the adviser, as a percentage of the total revenue of the entity that employs the adviser;
- the policies and procedures of the entity that employs the adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the adviser with a member of the compensation committee;
- any stock of the issuer owned by the adviser, including his or her immediate family members (but not, for this purpose, by the entity that employs the adviser); and
- any business or personal relationship of the adviser or the entity that employs the adviser with an executive officer of the issuer (*e.g.*, the CEO and the adviser have a familial relationship, the CEO and the adviser or the adviser's employer are business partners, etc.) – this is a new independence factor that the SEC added in the final rule.

The SEC declined to adopt any materiality, numerical or other bright-line thresholds with respect to these factors. The SEC expressed its view that the foregoing factors should be considered in their totality and that no one factor should be viewed as a determinative factor of independence.

This independence assessment applies to any compensation consultant or other adviser that provides advice to the compensation committee, other than in-house counsel. Accordingly, the SEC expects that compensation committees will likely need to create procedures for collecting and analyzing information about potential compensation advisers before they can receive advice from those advisers.

The SEC does not require issuers to describe the compensation committee's process for selecting compensation advisers pursuant to the new listing standards. In this regard, it noted that any such disclosure would increase the length of proxy statement disclosures on executive compensation without necessarily providing additional material information to investors.

Disclosure of Use of Compensation Consultants

In response to various comments to its proposal, the SEC decided to keep existing Item 407(e)(3)(iii) of Regulation S-K, which requires issuers to disclose "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation" – specifically, issuers are currently already 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 consultants 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 SEC's new requirement mandates issuers to disclose the nature of any conflict of interest and how the conflict is being addressed, if the work of the consultant gives rise to any such conflict. To determine whether there is a conflict of interest, the six compensation adviser independence factors are among the factors that should be considered. For purposes of these disclosure requirements, including the new conflicts of interest disclosure, consulting on broad-based, non-discriminatory plans and the provision of non-customized survey data remain exempt from disclosure.

This disclosure requirement applies only with respect to compensation consultants and not to other advisers. Any issuer that is subject to the proxy disclosure rules must provide this disclosure, even if it is exempt from the listing standards described above.

Application of Rules to Certain Types of Companies

General Exemption, Controlled Companies and Smaller Reporting Companies

The exchanges are expressly permitted to consider whether any exemption from the listing standards described above is appropriate for any category of issuer, such as emerging growth companies under the recently enacted JOBS Act or other newly listed issuers. In addition, controlled companies (*i.e.*, companies where a single investor or group of investors hold more than 50% of the voting power for the election of directors) and smaller reporting companies are exempt from complying with these listing standards, but not from the consultant conflicts of interest disclosure.

Limited Partnerships, Bankruptcy and Open-End Management Investment Companies

Limited partnerships, as well as companies in bankruptcy proceedings and open-end management investment companies registered under the Investment Company Act of 1940, are exempt from the compensation committee independence requirements, but not from the compensation adviser requirements (absent further action from the exchanges) or the consultant conflicts of interest disclosure.

Foreign Private Issuers

Foreign private issuers that disclose in their annual reports the reasons that they do not have an independent compensation committee are exempt from the compensation committee independence requirements, but not from the compensation adviser requirements (absent further action from the exchanges). Foreign private issuers are generally exempt from the proxy rules and, therefore, will not be required to provide the new disclosure relating to compensation consultants.

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