SEC Finalizes Rules for Compensation Committee and Adviser Independence
(Few Changes from Rules Proposed in April 2011)

On June 20, 2012, the Securities and Exchange Commission (“SEC”) issued final rules to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Act”). The final rules include few differences from the rules initially proposed by the SEC in March 2011.

The final rules address the following requirements of the Act:

- Compensation committee (“Committee”) members must be independent;
- A Committee may only select an adviser (e.g., compensation consultant; legal counsel) after considering certain factors that bear on the independence of the adviser;
- The Committee must have sole discretion to retain the adviser and the issuer is responsible for providing appropriate funding; and
- The issuer’s proxy statement must disclose whether the Committee used a compensation consultant and, if so, whether any conflict of interest was raised and how it was resolved.

The principal changes in the final rules are:

- The definition of Committee includes, for certain purposes, members of the board of directors who oversee executive compensation on the board’s behalf if there is no compensation committee or other board committee performing typical compensation committee functions;
- An additional independence factor is to be considered by the Committee when selecting an adviser; and
- The conflict of interest disclosure applies to a compensation consultant retained by management if the consultant’s role is otherwise required to be disclosed under existing SEC rules.

The individual exchanges are required to adopt listing standards that will serve as the detailed rules (as a result, for example, rules adopted by the NYSE will be the key document in determining how the new Committee independence rules apply to companies listed on the NYSE).

The final rules were published in the Federal Register today and will be effective 30 days after publication. The final SEC rules require the securities exchanges to issue proposed rules (which

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1 NYSE rules require listing companies to have a compensation committee, while NASDAQ rules do not.
the SEC must approve) within 90 days after publication of the rules in the Federal Register, and to issue final rules one year after publication. However, the new disclosure rules apply to definitive proxy statements for annual meetings that occur on or after January 1, 2013.

Committee Independence

The SEC’s final rules prohibit the listing of an equity security by a securities exchange unless each member of listed company’s compensation committee\(^2\) is: (i) a member of the board of directors; and (ii) independent\(^3\). The definition of independence may differ by exchange, but the following factors must be considered:

- The source of compensation of a member of the board of directors (including consulting, advisory, or other compensatory fees paid by the issuer); and
- Whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

In issuing the final rules, the SEC has emphasized that exchanges should consider other factors that may affect the judgment of a director as a compensation committee member, such as share ownership and personal or business relationships between a director and the issuer’s executive officers.

Under the Act (and the final SEC rules), the Committee independence rules do not apply to several categories of listed companies, including controlled companies (one person or entity owns more than 50% of voting stock) and foreign private issuers (if the issuer explains in its annual report the reasons that it does not have an independent Committee). Exemptions also apply to certain categories including limited partnerships and companies in bankruptcy. In addition, the securities exchanges are given authority to exempt other categories of issuers from the independence requirement.

Adviser Selection, Independence, and Proxy Disclosure Rules

The SEC’s final rules regarding consultant independence are generally consistent with the language in the Act, which is described in our letter of June 29, 2010, “Executive Compensation and Corporate Governance Provisions in Dodd-Frank Bill.”\(^4\) The SEC’s final rules give the securities exchanges authority to elaborate on these rules. Unlike the Committee independence standards, the adviser independence standards are not factors that must be met, but factors that must be taken into account by the Committee\(^5\) in selecting its advisers. The final rules do not

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\(^2\) Note that the rules do not require an issuer to have a compensation committee.

\(^3\) This independence requirement applies to any committee of the board that performs functions typically performed by a compensation committee, including oversight of executive compensation (regardless of whether it is actually called a “compensation committee”), as well as members of the board of directors who oversee executive compensation on the board’s behalf if there is no compensation committee or other such board committee.

\(^4\) http://www.fwcook.com/alert_letters/06-29-10_Executive_Compensation_and_Corporate_Governance_Provisions_in_Dodd-Frank_Bill.pdf

\(^5\) Including, as discussed above, any other board committee that performs functions typically handled by the compensation committee and board members who oversee executive compensation if there is no compensation committee or other such board committee.
require compensation committees to get advice only from independent advisers, and only apply to advisers retained by the Committee. The final rules set forth the following factors to be considered, the first five of which are listed in the Act:

- The provision of other services to the issuer by the company that employs the adviser;
- The amount of fees provided by the issuer to the company that employs the adviser as a percentage of total revenues;
- The policies and procedures that the company that employs the adviser has in place to prevent conflicts of interest;
- Any business or personal relationships between the adviser and any member of the Committee;
- Whether any of the issuer’s stock is owned by the adviser; and
- Any business or personal relationships between the issuer’s executive officers and the adviser or the company employing the adviser.

The revisions to the proxy disclosure rules require issuers to (i) continue to disclose any role of compensation consultants in determining or recommending executive (and director) compensation (subject to certain exceptions); and (ii) determine whether the resulting work (including, if applicable, the work of a compensation consultant retained by management) has raised any conflict of interest (and the nature of the conflict), and how any such conflict is being addressed.

Although the Committee independence standards do not apply to foreign private issuers that disclose the reasons why they do not have independent Committees in their annual reports, these issuers will be subject to the requirement that the Committee consider the independence of consultants and other advisers.

**Implications Relating to Compensation Committee Adviser Selection and Independence**

Set forth below are potential implications to be considered by the Compensation Committee and their advisers relating to the SEC’s final rules for the selection and independence of Committee advisers.

**Compensation Committees**

- Consider whether the Committee should develop a written policy on the independence of its advisers, including whether there should be a different policy for the compensation consultant compared to other advisers
  - If a policy is established, consider whether the policy should be publicly disclosed, including the details and location of the disclosure;
- Decide whether the rules regarding the six independence factors (and any other factors adopted by the applicable exchange) relating to the Committee's determination of an adviser’s independence apply only to the selection of new advisers (including re-evaluation of retaining current advisers) or whether current advisers should be screened, as well
If the latter, begin the evaluation process in the next few months and complete it prior to the end of the current fiscal year (or shortly thereafter) in order to be able to briefly describe the process and results in the 2013 proxy; and

- Decide whether the process of evaluating independence should occur annually, including whether the Committee's advisers should annually affirm compliance with the Committee's independence policy, and be required to immediately alert the Committee of any change that may affect the adviser’s independence.

**Compensation Committee Advisers**

- Adopt firm-wide written policies on independence and identifying and preventing potential conflicts of interests
  - Establish procedures for monitoring compliance with the policies;
  - Consider whether to communicate the policies and procedures to current and potential clients, as appropriate; and
- Consider whether to establish internal policies on issues including trading in client securities (including derivatives) and personal relationships with clients’ executive officers and compensation committee members.

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice. General questions about the subjects in this letter may be directed to Alexa Kierzkowski at 310-734-0110 (akhierzkowski@fwcook.com) or Richard Alpern at 212-299-2599 (rlalpern@fwcook.com). Copies of this letter and other published materials are available on our website at [www.fwcook.com](http://www.fwcook.com).