

Alert

SEC Disclosure and Corporate Governance

Dodd-Frank Update:

SEC Requires Disclosure of Compensation Consultant Conflicts and Directs Stock Exchanges to Propose Independence Standards for Compensation Committees and Their Advisers

- Disclosure Rule Applies to Proxy Statements for Meetings Held on or After January 1, 2013
- Stock Exchanges Must Propose Listing Standards by September 25, 2012

Last week, the U.S. Securities and Exchange Commission adopted rules requiring all companies subject to the SEC proxy rules (whether or not listed on an exchange) to disclose compensation consultant conflicts of interest. In addition, the SEC directed the national securities exchanges (including the NYSE and Nasdaq) to propose listing standards relating to compensation committee and adviser independence.¹ The rules begin to implement Section 952 of the Dodd-Frank Act and were adopted substantially as proposed by the SEC in March 2011.

The new rules:

- Require disclosure of compensation consultant conflicts of interest and how such conflicts are addressed, supplementing existing disclosure requirements.
 - New disclosure, if needed, must be included in proxy statements for an annual or special meeting at which directors are to be elected occurring *on or after January 1, 2013* and will apply to all companies that are subject to the proxy rules (whether or not listed on an exchange).
- Direct each national stock exchange to propose its own heightened listing standard for the independence of compensation committee members and evaluation of the independence of their advisers, which, subject to certain exceptions, will apply to companies that have listed equity securities.
 - Each stock exchange is required to consider two factors in developing its heightened independence criteria for compensation committee independence, which are similar to the standards mandated for audit committee independence. However, the SEC has not prescribed any *per se* bars.
 - Compensation committees of listed companies will be required to consider certain enumerated factors *prior to* engaging (or obtaining advice from) compensation consultants, legal counsel and other advisers. However, the SEC does *not* mandate that exchanges require compensation committees to obtain advice only from *independent* advisers.
 - Compensation committees of listed companies must also have the sole discretion and adequate funding to retain compensation consultants, legal counsel and other advisers.
 - Each exchange must propose a listing standard by September 25, 2012, and the SEC must approve such standards by June 27, 2013.

Timing and Applicability

The new disclosure rule regarding compensation consultant conflicts of interest will apply to any proxy statement in connection with an annual meeting at which directors are to be elected occurring on or after January 1, 2013. Whether the new listing standards on compensation committee and adviser independence will be in place for the 2013 proxy season will depend on how quickly the exchanges propose, and how quickly the SEC approves, the listing standards.

New Rule	Applicability	Timing
Disclosure of Compensation Consultant Conflicts of Interest	Applies to all companies subject to the SEC proxy rules (whether or not listed on an exchange), including controlled companies, smaller reporting companies. ²	To be included in proxy (or information) statements for an annual meeting (or a special meeting in lieu thereof) at which directors are to be elected occurring on or after January 1, 2013.
Listing Rules on Independence of Compensation Committees and their Advisers	Applies to companies that have equity securities listed on a national securities exchange. Controlled companies ³ and smaller reporting companies ⁴ will be exempt from these new listing standards. ⁵ The following issuers will be exempt only from the compensation committee independence standards: (1) limited partnerships; (2) companies in bankruptcy proceedings; (3) open-end management investment companies registered under the Investment Company Act of 1940; and (4) foreign private issuers that provide annual report disclosure to shareholders of reasons why they do not have an independent compensation committee. Each exchange may exempt other categories of issuers.	NYSE and Nasdaq to propose listing standards by September 25, 2012. The SEC must approve final listing standards by June 27, 2013.

We expect that the final listing standards to be proposed and adopted in the future will provide guidance on transition or phase-in periods, including for newly public companies. The listing standards also provide companies with an opportunity to cure defects in compliance with the compensation committee independence requirements that would otherwise result in delisting.

New Disclosure Requirement Regarding Compensation Consultant Conflicts

Beginning with their proxy statements for annual meetings to be held on or after January 1, 2013, companies subject to the SEC proxy rules (whether or not listed and whether or not exempt from the listing rules described below) will have an additional disclosure requirement for conflicts of interest with individual compensation consultants. Currently, Item 407(e)(3)(iii) of Regulation S-K requires

that companies disclose, among other things, the nature and scope of any services provided by a compensation consultant who has any role in determining or recommending the amount or form of executive and director compensation during the last completed fiscal year.⁶ In addition to describing the role of such compensation consultants, among other things, companies are already required to disclose the aggregate fees paid to a consultant relating to any additional services provided if fees for the additional services exceeded \$120,000 during the fiscal year.

The existing requirements will now be expanded by new Item 407(e)(3)(iv), which requires companies to disclose, with respect to any compensation consultant identified pursuant to Item 407(e)(3)(iii), the nature of any conflicts of interest raised by the work of such consultant and how the conflict is being addressed.

Disclosure of *potential* conflicts of interest or the *appearance* of a conflict of interest is not required, nor is disclosure with respect to advisers other than compensation consultants.⁷

The SEC has not defined the term “conflict of interest,” but requires that the following six factors⁸ are considered in determining whether a conflict of interest exists:

1. whether the firm employing the consultant is providing any other services to the company;
2. the amount of fees received from the company by the firm employing the consultant, as a percentage of that firm’s total revenue;
3. what policies and procedures have been adopted by the firm employing the consultant that are designed to prevent conflicts of interest;
4. any business or personal relationship of the consultant (not the firm) with a member of the compensation committee;
5. any business or personal relationship of the consultant or the firm employing the consultant with an executive officer of the company⁹; and
6. whether the consultant (not the firm) owns any stock of the company.

These considerations may need to be evaluated for more than one compensation consulting firm and for more than one consultant in such firm.

Implications: Any company expecting to file a proxy statement for a meeting at which directors will be elected to be held on or after January 1, 2013 will need to evaluate whether any conflict of interest that would require disclosure exists.

Compensation Committee Independence

New Exchange Act Rule 10C-1(b)(1), which implements the Dodd-Frank Act, directs each national securities exchange (including the NYSE and Nasdaq) to propose a listing rule requiring that compensation committee members satisfy a heightened independence standard. In developing a heightened standard, each exchange must consider the following two factors:

- The source of compensation of the director, including any consulting, advisory, or other compensatory fees paid by the listed company to such director; and

- Whether the director is affiliated with the listed company or any of its subsidiaries or their affiliates.

The factors that each exchange must consider are similar to the requirements for audit committee independence under Exchange Act Rule 10A-3 and the Sarbanes-Oxley Act of 2002. While the audit committee rule is prescriptive with respect to the stock exchanges, the compensation committee rule does not provide a specific mandate – only that the exchanges consider the two factors. Accordingly, the exchanges have greater flexibility in fashioning a listing standard.¹⁰

Given the flexibility afforded to the stock exchanges, it is possible that the NYSE and Nasdaq may propose independence standards that differ from each other and/or from the audit committee standards. As a result, boards of directors and companies may have yet another “independence standard” to evaluate (in addition to existing standards of independence under the NYSE and Nasdaq listing rules, Exchange Act Rule 10A-3, the definition of “non-employee” director under Exchange Act Section 16 and the definition of “outside director” under Section 162(m) of the Internal Revenue Code).

Implications for Compensation Committee Members Affiliated with Significant Stockholders:

A key element of the proposed standard to watch for is whether (by analogy to audit committee independence requirements) directors who are affiliated¹¹ with significant stockholders, including private equity funds, will not be eligible for compensation committee membership. The SEC adopting release noted the concern of several commentators that Rule 10C-1(b)(1) not prohibit directors who are affiliated with significant investors (such as private equity funds and venture capital firms) from serving on compensation committees. In the adopting release, the SEC expressly gave the exchanges the freedom to determine that, even though affiliated directors are not permitted to serve on audit committees under Rule 10A-3, such a blanket prohibition may be inappropriate for compensation committees, and that certain affiliates, such as representatives of significant stockholders, could be permitted to serve on the compensation committee.¹²

Independence of Consultants and Other Advisers

The SEC’s directive to the exchanges does *not* require that a compensation consultant, legal counsel or other adviser to a listed company’s compensation committee be independent. The SEC adopting release clarifies that a compensation committee may obtain advice from non-independent advisers, including those engaged by management.

However, the SEC rule requires that *prior to* selecting (or receiving advice from) a compensation consultant, legal counsel or other adviser, the compensation committee must evaluate the independence of such adviser in light of the six factors enumerated in new Rule 10C-1(b)(4), as well as any other factors developed by the applicable exchange. The six factors are the same ones identified above to determine whether a conflict of interest exists with respect to a compensation consultant, but must be applied to evaluate the independence of legal counsel and other advisers, as well as compensation consultants.¹³ The SEC included an instruction to new Rule 10C-1(b)(4) that requires the compensation committee to conduct the independence assessment with respect to any compensation consultant, legal counsel or other adviser that provides advice to the compensation committee, *including those retained by management or the company*. The SEC explained that information gathered from an independence

assessment of such advisers will be useful to the compensation committee as it considers any advice they may provide.¹⁴

The compensation committee will not, however, need to consider the independence of in-house attorneys prior to consulting with them, as they are company employees that are not held out to be independent.¹⁵

Implications: As specifically noted by the SEC, compensation committees will need to create procedures for collecting and analyzing information about compensation consultants, legal counsel and other advisers prior to receiving advice from them.¹⁶

Other Listing Standard Requirements

To ensure that companies do not avoid the new rules by simply not establishing a formal compensation committee,¹⁷ new Rule 10C-1(c)(2) defines “compensation committee” to encompass (1) any other committee of the board of directors performing functions typically performed by a compensation committee and (2) the members of the board of directors who, in the absence of a formal committee, oversee executive compensation matters.¹⁸ The rule does not, however, apply to a committee that addresses only director compensation, so (unless the exchanges go further than the SEC’s directive) it appears that the typical governance committee would not be subject to the heightened compensation committee independence standards.

The SEC directed the exchanges to adopt standards (similar to those that presently exist for audit committee advisers) requiring that compensation committees have the sole discretion and adequate funding to retain and oversee the work of compensation advisers retained by the compensation committee (not by management). This rule is not likely to have a significant impact as most companies already have similar requirements in their compensation committee charters.

How to Prepare for the New Disclosure Rule and Anticipated Listing Standard

- *Consider Changes to Compensation Consultant Disclosures in Annual Proxy Statements.*
A company expecting to file a definitive proxy statement for a meeting at which directors are elected to be held on or after January 1, 2013 should immediately focus on the six factors enumerated in the rules in order to evaluate whether disclosure regarding any conflict of interest with a compensation consultant would be required.
- *Review and Amend Compensation Committee Charter.*
 - Compensation committee charters should be revised to include as a part of the duties and responsibilities of the compensation committee, the evaluation of conflicts of interest with any compensation consultant in accordance with new Item 407(e)(iv) of Regulation S-K.
 - Once the exchanges’ independence standards are adopted, compensation committee charters of listed companies should be amended to reflect: (1) any heightened independence criteria for membership; (2) as a part of the duties and responsibilities of the committee, assessing the independence of any compensation consultant, legal counsel or other adviser from whom the committee receives advice, in accordance with applicable listing standards; (3) if not already included, the authority of the compensation committee to appoint, compensate and oversee the work of compensation advisers, and the obligation of the

company to provide reasonable compensation to such advisers; and (4) any established policy governing the independence or retention of advisers.

- *Update D&O Questionnaires.* D&O Questionnaires should be reviewed and updated to capture information about business or personal relationships with compensation consultants to assess whether disclosure under new Item 407(e)(iv) of Regulation S-K is required. For example, the questionnaire should elicit responses regarding (1) any business or personal relationship of the compensation consultant with a member of the compensation committee and (2) any business or personal relationship of the compensation consultant or the firm employing the consultant with an executive officer of the company. In addition, once the exchanges' listing standards are adopted, listed companies should revise their D&O Questionnaires to address any other independence criteria applicable to compensation committees and their advisers.
- *Adjust Disclosure Controls and Procedures.* All companies should adjust disclosure controls and procedures to ensure that information relating to compensation consultant conflicts of interest is captured and disclosed.
- *Consider Adopting Adviser Retention Procedures.* Companies should consider establishing specific procedures for compensation committees to follow *prior to* retaining or receiving advice from a compensation consultant, legal counsel or other adviser in order to ensure that, when the exchanges' listing standards are adopted, six (or more) independence factors are considered. Companies should also consider obtaining representations and agreements from compensation committee or management advisers addressing the six factors, as applicable, in engagement letters.
- *Review Compensation Committee Composition and Consider Independence.* As a result of the new rules it is possible that some directors who may have been considered independent for compensation committee purposes will no longer qualify when the exchanges establish their own independence standards. Companies should review and consider the composition of their compensation committees (and those board members or other committees overseeing executive compensation).
- *Review Functions of Other Committees.* Companies should review and evaluate the functions of other committees to determine whether the enhanced independence standards could apply to directors serving on any committee overseeing executive compensation even if the committee is not designated as a compensation committee or performs other functions as well.

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any of the following:

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Endnotes

- ¹ SEC Release No. 33-9330, Listing Standards for Compensation Committees (June 20, 2012), *available at* <http://www.sec.gov/rules/final/2012/33-9330.pdf> (the “Adopting Release”).
- ² *See* Adopting Release at 78.
- ³ A controlled company is a listed company in which more than 50% of the voting power for the election of directors is held by an individual, a group or another company. *See* Exchange Act Rule 10C-1(c)(3).
- ⁴ *See* Exchange Act Rule 12b-2.
- ⁵ We expect that some controlled companies and smaller reporting companies will nevertheless choose to subject themselves to the new listing standards.
- ⁶ Currently, Item 407(e)(3)(iii) of Regulation S-K requires companies subject to the SEC proxy rules to, subject to certain exceptions: (i) identify the consultants; (ii) state whether such consultants were engaged directly by the compensation committee or any other person; (iii) describe the nature and scope of the consultant’s assignment; (iv) describe the material elements of the instructions or directions given to the consultants under the engagement; and (v) 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.
- ⁷ *See* Adopting Release at 79.
- ⁸ *See* Adopting Release at 31-32, 66.
- ⁹ This factor was added in response to comments. Examples of relationships that would fall under this factor include, situations where the CEO and the compensation consultant have a familial relationship or where the CEO and the compensation consultant (or such consultant’s employer) are business partners. *See* Adopting Release at 39-40.
- ¹⁰ *See* Adopting Release at 23-24.
- ¹¹ In adopting Exchange Act Rule 10A-3, the SEC specifically determined that executive officers, employees, general partners and managing members of an affiliate will be deemed to be affiliates of the issuer and therefore be ineligible to serve on the audit committee. *See* SEC Release No. 33-8220 (April 9, 2003).
- ¹² *See* Adopting Release at 20-22, 24. Note, however, that even if affiliates of significant stockholders are not expressly barred from service on the compensation committee under the new listing standards, an issue often arises as to whether designees of significant stockholders qualify as “non-employee” directors under Exchange Act Rule 16b-3, which disqualifies directors who receive compensation, directly or indirectly, from the issuer or a *parent*.
- ¹³ Additional factors developed by the exchanges must be competitively neutral among categories of consultants, legal advisers and other advisers. *See* Adopting Release at 31.
- ¹⁴ *See* Adopting Release at 41.
- ¹⁵ *See* Adopting Release at 41.
- ¹⁶ *See* Adopting Release at 63.
- ¹⁷ The SEC determined not to require listed issuers to have a formal compensation committee. Nasdaq does not require a formal compensation committee and permits compensation decisions to be made by independent directors constituting a majority of the board’s independent directors in a vote in which only the independent directors participate. *See* Nasdaq Marketplace Rules, Rule 5605(d). The NYSE requires listed companies to establish a formal compensation committee composed entirely of independent directors. *See* NYSE Listing Company Manual Section 303A.05.
- ¹⁸ The SEC determined it was not necessary to require the exchanges to apply the listing standards related to the compensation committee’s authority to retain compensation advisers or require funding for payment of such advisers to directors who oversee executive compensation matters outside of the formal committee structure since such directors already retain the powers of the board of directors in making executive compensation determinations. *See* Adopting Release at 12-13.