

Dodd-Frank Corporate Governance Final Rules: Compensation Committee and Adviser Independence

On June 20, 2012, the U.S. Securities and Exchange Commission (the “SEC”) released its final rules (the “Final Rules”) implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Section 952 of the Dodd-Frank Act (“Section 952”) added Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”) and contains a number of provisions generally relating to the independence of compensation committees and their advisers. The Final Rules are in most respects identical to the proposed rules released on March 30, 2011 (the “Proposed Rules”).¹ Below is a summary of the provisions of the Final Rules, noting the key changes from the Proposed Rules.

I. Major Components of Section 952

- Section 952 required the SEC to adopt rules requiring the national securities exchanges (the “Exchanges”) to prohibit the listing of any security of an equity issuer that does not comply with listing rules regarding:
 - compensation committee member independence (“CC Independence Requirements”) (see Section IV below),
 - a compensation committee’s authority to engage (and pay for) compensation advisers (“CC Authority to Engage Compensation Advisers”) (see Section V below) and
 - a compensation committee’s consideration of certain relevant factors in selecting a compensation adviser (“CC Selection of Compensation Advisers”) (see Section VI below).

¹ For a detailed summary and discussion of the Proposed Rules, please see our previous alert memo: Dodd-Frank Corporate Governance Proposed Rules: Compensation Committee and Adviser Independence (available at http://www.cgsh.com/dodd-frank_corporate_governance_proposed_rules_compensation_committee_and_adviser_independence/).

- Section 952 also required the SEC to adopt rules regarding disclosure relating to a compensation consultant's conflicts of interest ("Compensation Consultant Conflicts of Interest Disclosure") (see Section VII below).

II. Timing of Implementation

- The Dodd-Frank Act did not prescribe a deadline by which the Exchanges' listing rules must become effective. The Final Rules require that each Exchange provide to the SEC proposed listing rules or rule amendments consistent with the Final Rules not later than 90 days after publication of the Final Rules in the Federal Register and that the proposed listing rules or rule amendments must be approved by the SEC no later than one year after publication of the Final Rules in the Federal Register.
- The Final Rules require the Compensation Consultant Conflicts of Interest Disclosure to be included in proxy or information statements for an annual meeting of shareholders (or a special meeting in lieu of an annual meeting) at which directors will be elected occurring on or after January 1, 2013.

III. Who is Covered by the Final Rules

- The Final Rules exempt from the CC Independence Requirements (1) limited partnerships, (2) companies in bankruptcy, (3) open-ended management investment companies and (4) foreign private issuers that provide annual disclosure of the reasons why they do not have an independent compensation committee.
- Issuers of listed debt securities only are not subject to any of the Final Rules.
- Foreign private issuers are generally subject to the Final Rules, except those that disclose in their annual reports the reasons they do not have an independent compensation committee are exempt from the CC Independence Requirements. We note that the Exchanges have generally exempted foreign private issuers from their corporate governance requirements, instead deferring to home country rules or practices.
- Foreign private issuers, which are not subject to the U.S. proxy rules, will not be subject to the Compensation Consultant Conflicts of Interest Disclosure requirement.
- The Final Rules clarify that controlled companies are exempt from the listing rules and expand the definition of "controlled company,"² which is defined

² In the Proposed Regulations, "controlled company" is defined as an issuer that holds an election for the board of directors of the issuer in which more than 50% of the voting power is held by an individual, a group or another issuer.

therein as a listed company where more than 50% of the voting power for the election of directors is held by an individual, group or another company.

- The Final Rules provide that smaller reporting companies are exempt from the listing rules.
- The Final Rules clarify that, subject to review and approval by the SEC, the Exchanges may exempt transactions or categories of issuers from the listing rules, considering factors they deem relevant beyond the potential impact of the rules on smaller reporting issuers.

IV. Compensation Committee Independence Requirements (Final Rule 10C-1(b)(1))

Definition of Independence

Independence Factors. To implement the CC Independence Requirements, consistent with Section 952, the Final Rules require each member of a listed issuer's compensation committee to be (i) a member of the issuer's board of directors and (ii) "independent."

The Final Rules direct the Exchanges to establish a definition of "independence" taking into account relevant factors, including the following factors, which were included in the Proposed Rules and in Section 952:

- the sources of a compensation committee member's compensation (including consulting, advisory or other compensatory fees paid to the compensation committee member by the issuer) and
- whether the compensation committee member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The SEC did not create any safe harbors for particular relationships between members of a compensation committee and an issuer, but acknowledged that the Exchanges may exempt particular relationships in their discretion.

Independence Determination. The Final Rules do not require a look-back period with respect to relationships existing before a member of the compensation committee is appointed.

Committees Subject to the CC Independence Requirements

The Final Rules apply to a listed issuer's compensation committee, or if there is no such committee designated, to any other board committee (regardless of its official designation) that performs duties routinely performed by a compensation committee. Unlike

the Proposed Rules, the Final Rules extend the CC Independence Requirements to individual directors responsible for a compensation committee's typical duties.

Cure Provisions

Section 952 requires that there be a reasonable opportunity to cure violations of the Exchanges' listing rules before an issuer is delisted or prohibited from being listed. The Final Rules require the listing rules to provide that if a compensation committee member ceases to be independent for reasons beyond the member's control, the member may, with notice by the issuer to the applicable Exchange, remain a compensation committee member until the earlier of the next annual meeting of shareholders and one year from the occurrence of the event that caused the member to no longer be independent.

V. Compensation Committee Authority to Engage Compensation Advisers (Final Rule 10C-1(b)(2), (3))

The Final Rules implement Section 952's provisions regarding compensation committees' authority to engage compensation advisers without any changes, except that the Final Rules clarify that these provisions apply only to compensation advisers retained by the compensation committee. The provisions require an Exchange to require a listed issuer to give its compensation committee the authority, exercised in its sole discretion, to retain or obtain an independent compensation consultant, legal counsel or other adviser (each, a "compensation adviser") and to provide the compensation committee with sufficient funding for such retention. The Final Rules do not require that individual directors responsible for a compensation committee's typical duties be given authority to engage compensation advisers, as the SEC noted that their actions would be attributed to the entire board.

VI. Compensation Committee Selection of Compensation Advisers (Final Rule 10C-1(b)(4))

Requirements

Section 952 also provides that a compensation committee must consider certain relevant factors identified by the SEC when selecting a compensation adviser to the compensation committee.

Section 10C(b) of the Exchange Act provides that while a compensation adviser is not required to be independent, a listed company's compensation committee must undertake an evaluation of a compensation adviser's independence during the selection process. A compensation committee may retain non-independent legal counsel and use in-house counsel or outside counsel retained by the issuer or management and is not required to hire "independent legal counsel." The Final Rules clarify that, other than with respect to in-house counsel, a compensation committee must consider the independence of any adviser from which it obtains advice, including outside counsel retained by the issuer or management.

Unlike the Proposed Rules, the Final Rules extend the requirement to consider the independence of a compensation adviser to individual directors responsible for a compensation committee's typical duties.

Final Rule 10C-1(b)(4) repeats the factors listed in Section 952 as those relevant to a determination of a compensation adviser's independence, noting that determining which factors are relevant in a given case requires consideration of the particular facts and circumstances, and adds the requirement to consider the compensation adviser's relationships with an issuer's executive officers. The six factors are:

- whether a compensation adviser's employer provides other services to the issuer,
- the amount of fees the compensation adviser's employer receives from the issuer as a percentage of such employer's total revenues,
- the compensation adviser's policies and procedures to prevent conflicts of interest,
- business or personal relationships between a compensation adviser and any member of the issuer's compensation committee,
- the compensation adviser's stock ownership in the issuer and
- business or personal relationships between a compensation adviser or the compensation adviser's employer and any executive officer of the issuer.

Given that the factors are for consideration only, and are not standards for independence, the Final Rules, like the Proposed Rules, do not provide for any materiality or bright-line thresholds. The Final Rules provide the Exchanges with the discretion to add other independence factors that must be considered by a compensation committee of a listed issuer.

VII. Compensation Consultant Conflicts of Interest Disclosure

Conflicts of Interest Disclosures

The Final Rules require that in any proxy or information statement in connection with an annual meeting of shareholders (or a special meeting in lieu of an annual meeting) at which directors will be elected occurring on or after January 1, 2013, an issuer must disclose:

- whether the compensation committee has retained or obtained the advice of a compensation consultant,
- whether the compensation consultant's work has raised any conflicts of interest,

- if a conflict of interest has arisen, the nature of such conflict of interest and
- how such conflict of interest is being addressed.

The Final Rules provide that the six factors to be considered when evaluating a compensation adviser's independence should also be considered in determining whether a conflict of interest has arisen with respect to a compensation consultant.

Item 407(e)(4) of Regulation S-K

In the Proposed Rules, the SEC proposed integration of the Compensation Consultant Conflicts of Interest Disclosure with existing Regulation S-K disclosure requirements in Item 407(e)(3)(iii) relating to conflicts of interest that may arise when a compensation consultant also provides other services to the issuer. Instead, the Final Rules provide a new subsection 407(e)(3)(iv), which requires disclosure of the nature of the conflict of interest and how it is being addressed for any compensation consultant identified in existing Item 407(e)(3)(iii), regardless of whether such compensation consultant was retained by management, the compensation committee or any other committee. Although the SEC requested comments in the Proposed Rules on whether the Final Rules should be extended to other compensation advisers, including, for example, independent legal counsel, the disclosure requirement is limited to compensation consultants.

Under current Item 407(e)(3), exclusions from disclosure apply for consulting services:

- relating to broad-based plans that do not discriminate in favor of executives or directors,
- that do not provide customized information for a particular registrant or
- that are customized, but not based on criteria set by the compensation consultant, if no related advice is provided by the compensation consultant.

Under the Final Rules, these exclusions also apply to the Compensation Consultant Conflicts of Interest Disclosure.

Registrants Subject to the Disclosure

Under the Final Rules, the Compensation Consultant Conflicts of Interest Disclosure requirement applies to Exchange Act registrants subject to the U.S. proxy rules, regardless of whether such registrant is or is not listed on an Exchange, and regardless of whether it is or is not a controlled company (despite the language of Section 952) or smaller reporting company. Further, the SEC clarified that foreign private issuers, which are not subject to the U.S. proxy rules, will not be subject to the disclosure requirement.

VIII. Next Steps

In anticipation of the new disclosure requirements and the Exchanges' implementation of the new listing requirements, we suggest that issuers subject to the new disclosure or listing requirements begin to consider the following next steps:

1. Implementing a new, or updating an existing, written policy to address independence determinations for members of the compensation committee (whether current or prospective), including consideration of the factors identified as relevant in the CC Independence Requirements and any additional considerations deemed relevant by the applicable Exchange, including documentation of the independence evaluation process as it relates to each prospective and current member of the compensation committee (e.g., detailing in board minutes the factors considered and determinations made for each current and prospective committee member).
2. Evaluating the independence of current members of the compensation committee and beginning to make preparations, subject to the Exchange rules, to replace members who are determined to not be independent (including through utilization of cure provisions).
3. Updating director and officer questionnaires to reflect the factors identified in the CC Independence Requirements and any additional considerations deemed relevant by the applicable Exchange.
4. Reviewing compensation committee charters to ensure the committee has the necessary authority and budget to engage compensation advisers.
5. Implementing new, or updating existing, written policies for analyzing the independence of compensation advisers, including consideration of the factors identified as relevant to the compensation committee selection of compensation advisers and any additional considerations deemed relevant by the applicable Exchange. Such policies should include appropriate measures for documenting the evaluation processes as they relate to each prospective independent compensation adviser (e.g., detailing in board minutes the independence factors considered and determinations made for each compensation adviser).
6. Implementing new, or updating existing, written policies for analyzing whether conflicts of interest exist for compensation advisers, including consideration of the factors identified as relevant to compensation consultant conflicts of interest and any additional considerations deemed relevant by the applicable Exchange. Such policies should include appropriate measures for documenting the evaluation processes as they relate to each compensation adviser and potential conflicts of interest (e.g., detailing in board minutes the factors considered and determinations made for each compensation adviser in respect of potential conflicts of interest).

7. Requiring advisers to the compensation committee to complete a questionnaire incorporating factors identified as relevant to the compensation committee's selection of compensation advisers, including, for example, a compensation adviser's equity ownership in the registrant and any conflicts of interest policies of a compensation adviser's employer.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Corporate Governance" or "Executive Compensation and ERISA" under the "Practices" section of our website at <http://www.clearygottlieb.com>.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING

Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299