

Client Alert

June 29, 2012

SEC Finalizes Rules for Compensation Committee and Adviser Independence

New Standards Cover Any Director with Oversight of Executive Pay

Executive Summary

The SEC's Final Rules covering independence standards and related disclosures for Compensation Committees and their advisers were published in the Federal Register on June 27, 2012. As in its earlier Proposed Rules¹, the agency closely follows the statutory language of Section 952 of the Dodd-Frank Act and defers to the national stock exchanges (the Exchanges) on many points.

The Final Rules deviate from the Proposed Rules in two important respects:

- **Broad Applicability of Committee Independence Rules:** The Final Rules clarify that the independence rules for Compensation Committee members also apply to any Board member who serves in a role involved in executive compensation decisions. Thus, member independence will be considered even where no formal Compensation Committee exists, or where all Directors vote on executive compensation matters.
- **Conflicts of Interest:** As an additional factor that companies must consider in assessing the independence of an adviser, the SEC added the existence of any business or personal relationship between the adviser (or the entity that employs the adviser) and an executive officer.

This Client Alert discusses the Final Rules and highlights where they differ from or clarify the Proposed Rules. An updated timeline for implementation of all the compensation-related provisions under Dodd-Frank is provided at the end of this Alert.

¹ For details, see our previous Client Alert on the Proposed Rules at:
<http://pearlmeyer.com/Pearl/media/PearlMeyer/PDF/PMP-CA-SECProposesNewCCIndependence-4-11.pdf>

Overview and Timing

Like the SEC's Proposed Rules, the Final Rules provide guidance in four key areas:

- Compensation Committee Independence
- Compensation Committee Adviser Retention, Oversight and Funding
- Compensation Committee Adviser Independence
- Disclosure of Advisers and Conflicts of Interest

The Final Rules issued for the first three areas, above (referred to as the Listing Requirements) generally adopt the statutory language in Section 952. They represent, however, only the next step in a longer approval process: the Exchanges are now charged with developing their own detailed rules around Committee independence, authority and assessment of adviser independence. The timeline for finalization and implementation of the Listing Requirements is now as follows:

- **June 27, 2012:** Federal Register publication of the SEC Final Rules directing Exchanges to promulgate the Listing Requirements
- **By September 25, 2012:** Exchanges issue their proposed Listing Requirements, which must be approved by the SEC
- **By June 27, 2013:** SEC approves final Listing Requirements

Practically speaking, it is unclear if the Listing Requirements will be applicable during the 2013 proxy season unless the SEC and Exchanges work on an expedited basis. Only the fourth area – new disclosure requirements concerning adviser independence – is effective without further Exchange guidance, and will be applicable beginning with any proxy statement for an annual shareholders meeting at which Directors will be elected occurring on or after January 1, 2013.

PM&P Observation: Because the SEC's Final Rules provide little additional insight into Committee member independence, we anticipate most companies will await the Exchanges' guidance before taking any action. Companies should, however, now revisit their disclosures with regard to advisers and conflicts as such a review will be required in the next proxy.

Compensation Committee Independence

Committee Independence Factors

Section 952 requires the Exchanges to prohibit the listing of any company not meeting their new independence standards for members of Compensation Committees. In those standards, Dodd-Frank directs the Exchanges to take into consideration at a minimum:

- The sources of any additional compensation paid to Committee members by the company (including consulting, advisory or other fees); and
- Whether any Committee members are affiliated with the Company, its subsidiaries or affiliates.

Like the Proposed Rules, the Final Rules defer to the Exchanges to develop their own standards, reflecting the SEC's belief that the most equitable approach is to give each of the Exchanges flexibility to develop independence requirements appropriate to the companies it lists.

Applicability

The Final Rules confirm that Section 952 does not require that companies maintain a Compensation Committee, unless otherwise required by their Exchange. ***The Final Rules, however, expand the independence requirements to apply to any Director who, in the absence of a Compensation Committee, oversees executive compensation matters on behalf of the Board.***

This reflects a change from the Proposed Rules, which had suggested that the requirement would cover only members of the Compensation Committee or, in its absence, any other committee (such as Corporate Governance or Human Resources) responsible for its usual functions. The Proposed Rules did not anticipate applying the new independence standard to Board members who oversaw executive compensation in the absence of a formal Committee.

PM&P Observation: Going forward, companies will need to ensure that any compensation decisions previously made by the full Board preclude input from "non-independent" Directors (as defined by the applicable Exchange standards). The implications of these new standards may be limited, however, as Section 162(m) of the Internal Revenue Code and Section 16(b) of the Exchange Act already preclude such Directors' input.

Compensation Committee Retention, Oversight and Funding

The SEC's Final Rules essentially track the language of Dodd-Frank, compelling the Exchanges to issue listing standards requiring that:

- Compensation Committees have the sole authority, but are not required, to retain or obtain advice from compensation advisers, including consultants or legal counsel;
- Compensation Committees (or Directors overseeing executive compensation, in the absence of a Compensation Committee) are directly responsible for the appointment, compensation and oversight of the advisers' work; and
- Companies must provide appropriate funding for the payment of reasonable compensation to such advisers, as determined by the Compensation Committees.

The Final Rules confirm that Compensation Committees are not required to accept or act on any recommendations made by their outside advisers and may retain non-independent advisers (although doing so clearly poses problems in terms of conflicts and disclosure, discussed below). ***The Final Rules also provide additional guidance, clarifying that the direct responsibility to appoint, compensate and oversee the advisers applies only to those advisers retained by the Committee – and not to advisers retained by management.***

Compensation Committee Adviser Independence

Factors to be Considered

While neither Dodd-Frank nor the SEC require that compensation consultants, legal counsel or other advisers to the Compensation Committee be independent, they do identify certain non-exclusive factors that the Exchanges must incorporate when setting standards for their listed

companies to consider in selecting a compensation adviser. The Final Rules establish six such factors, ***including a new factor not in the Proposed Rules that covers advisers' relationships with executive officers:***

- ***Any business or personal relationships between the executive officers of the company and the compensation adviser or the person employed by the adviser. This would include situations in which the CEO and the compensation adviser are family members, or the CEO and adviser (or the adviser's employer) are business partners;***
- Other services provided by the adviser's firm to the company;
- Fees paid by the company as a percentage of the advisory firm's total revenue;
- Policies or procedures maintained by the adviser's firm to prevent a conflict of interest;
- Any business or personal relationship between the adviser and a Compensation Committee member; and
- Any company stock owned by the adviser.

The Final Rules also clarify that Compensation Committees must consider these six independence factors before consulting with, or obtaining advice from, legal advisers, with the exception of in-house counsel.

Like the Proposed Rules, the Final Rules do not provide any further guidance (including bright line tests or thresholds) for these factors.

Listing Requirement Cure and Exemptions

Opportunity to Cure

The Exchanges must provide a reasonable opportunity for companies to comply with the Listing Requirements they establish under the Final Rules. If a member of the Compensation Committee ceases to be independent for reasons outside the member's reasonable control, an Exchange may allow that person, with notice to the Exchange, to remain on the Committee until the earlier of the next annual meeting of the company or one year from the date on which the Director ceased being independent. The Exchanges may also provide other opportunities to cure defects.

Exemptions

Dodd-Frank exempts certain entities from compliance with the Listing Requirements. ***While the Proposed Rules had reiterated these exemptions, the Final Rules also provide an additional exemption for "smaller reporting companies," reasoning that smaller companies have more difficulty finding independent Directors and also are less likely to hire outside compensation consultants for financial reasons or because their programs tend to be less complex.***

Under the Final Rules, exemptions from all Listing Requirements will be available for:

- ***Smaller reporting companies (generally defined as having a public float of less than \$75 million); and***
- ***Controlled companies (clarified in the Final Rules to mean companies in which 50% of the voting power for the election of Directors is held by an individual, a group or another company).***

Exemption from only the Compensation Committee independence standards are available for:

- Limited partnerships;
- Companies in bankruptcy proceedings;
- Open-end management investment companies registered under the Investment Company Act of 1940;
- Any foreign private issuer that discloses in its annual report why it does not have an independent Compensation Committee; and
- Any further exemptions deemed appropriate by the Exchanges based on company size or other factors.

Disclosure of Advisers and Conflicts of Interest

Current proxy rules require all companies subject to SEC proxy rules to disclose any role of compensation consultants in determining or recommending the amount or form of executive and Director compensation, including:

- The consulting firm's identity;
- Whether the consulting firm was engaged directly by the Committee or by another person;
- The nature and scope of the assignment and the material instructions given to the firm; and
- Fees paid for executive/Director consultant services **and** fees paid for "other" services rendered by the same consultant, if the fees for the other services exceed \$120,000 for the fiscal year.

Notably, the Final Rules maintain two exemptions from those disclosure requirements that the Proposed Rules would have eliminated. The carve-outs preserved by the Final Rules apply in situations where the only services provided by the adviser are either:

- ***Advice on a broad-based plan that did not discriminate in scope, terms or operation in favor of executive officers or Directors of the company (broad-based consulting); or***
- ***Information not customized or customized based on parameters not developed by the consultant and about which the consultant did not advise (non-customized benchmark data).***

New Conflicts Disclosure

In line with the Proposed Rules, the SEC's Final Rules broaden consultant disclosure to include a discussion of conflicts of interest, as applicable. If a Committee identifies an adviser conflict, the proxy must clearly and concisely explain its nature and how it was addressed. It is not sufficient to provide only a general description of the company's policies and procedures to address conflicts.

The SEC declined to further define "conflict of interest," but indicated that the six factors used to assess Compensation Committee adviser independence (described above) would be relevant. The two consultant disclosure exemptions – broad-based consulting and non-customized survey data – also remain exempt from conflict disclosure.

Conclusion

Implementation of Section 952 (with the exception of the adviser disclosure rules) is still heavily dependent on further guidance from the Exchanges. Nonetheless, we advise that companies consider the following actions:

- Review the Compensation Committee charter to ensure it provides for the necessary authority, responsibility and funding requirements for advisers.
- Review any Committee engagement letters with compensation advisers to ensure the Committee is made directly responsible for appointing, compensating and providing oversight to the adviser.
- Review the independence status of Compensation Committee members and/or any other Directors involved in executive compensation decision-making. Determine which Directors would fail to be independent under the most stringent position an Exchange may take – the Audit Committee test – and address any issues in advance.
- Run the six-part conflicts test on your compensation consultants and outside legal advisers. While Committees are not prohibited from using non-independent advisers, they must be prepared to explain the need to retain such advisers – particularly for compensation consultants, whose conflicts will be subject to disclosure.
- If your compensation consultant “fails” any of the conflict tests, be prepared to disclose why the engagement was continued and why the conflict did not affect independence or impair advice generally.

Updated Implementation Schedule

Below is our evolving chart tracking the overall rulemaking process and likely implementation dates for the multiple compensation-related requirements of Dodd-Frank. As discussed above, while consultant disclosure rules will be in place for the 2013 proxy season, rules governing Committee and adviser independence could be delayed, depending on how quickly the SEC and Exchanges proceed. Final guidance for disclosure of pay-for-performance, the ratio of CEO pay to other employees, hedging and clawbacks is now expected by the end of this year, although it is likely this rulemaking will be delayed in light of the election process this November.

Provision	Effective Dates in DFA	Current Known Status or Scheduled Action
Say on Pay and Say on Frequency	Proxy statements for meetings on or after 1/21/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Say on Golden Parachute	Effective on or after 4/25/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Financial Institution Excessive Compensation Rules	Rules were to have been issued by 4/21/2011	Proposed Rules Issued by Joint Regulators April, 2011 Final Rules scheduled by Dec., 2012 Likely effective for 2013 proxy season
Compensation Committee & Adviser Independence; Committee's Oversight Authority	Rules were to have been effective by 7/16/2011	SEC issued Final Rules June, 2012 Exchanges to issue proposed rules by Sept. 25, 2012 Approved by SEC and effective no later than July 27, 2013
Disclosure of Compensation Consultant Conflict of Interest	Was to have applied to proxy statements for meetings occurring on or after 7/21/2011	SEC issued Final Rules June, 2012 Effective for 2013 proxy season
Clawback Policy	None stated	SEC to issue Proposed Rules by June, 2012 SEC to issue Final Rules by Dec., 2012 Likely effective for 2013 proxy season
Pay-for-Performance Disclosure	None stated	SEC to issue Proposed Rules by June, 2012 SEC to issue Final Rules by Dec., 2012 Likely effective for 2013 proxy season
Internal Equity Ratio Disclosure	None stated	SEC to issue Proposed Rules by June, 2012 SEC to issue Final Rules by Dec., 2012 Likely effective for 2013 proxy season
Disclosure of Hedging	None stated	SEC to issue Proposed Rules by June, 2012 SEC to issue Final Rules by Dec., 2012 Likely effective for 2013 proxy season
Disclosure of COB/CEO Roles	None stated, but it is so similar to 2010 rule that most companies have complied in the 2011 proxy	Effective for 2011 proxy season
Proxy Access	SEC issued final rules in 2010 but court struck down "universal" rule in July, 2011; companies may still submit proposals to change bylaws under Rule 14a-8	Rule 14a-8 effective for 2012 proxy season
Broker Non-Vote on Executive Compensation	Effective 7/21/10	SEC to issue clarifying Final Rules TBD Effective for 2011 proxy season

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