

SEC Proposes Compensation Committee Listing Standards and Compensation Consultant Disclosure Requirements as Mandated by the Dodd-Frank Act

On March 30, 2011, the U.S. Securities and Exchange Commission (SEC) unanimously approved its proposing release “Listing Standards for Compensation Committees,”¹ to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which added Section 10C to the Securities Exchange Act of 1934 (Exchange Act). This provision requires the SEC to adopt rules directing the national securities exchanges to prohibit the listing of equity securities of any issuer not in compliance with the compensation committee independence requirements and compensation adviser requirements set forth in the Dodd-Frank Act, and to adopt disclosure rules concerning compensation consultants and conflicts of interest. The proposed rules closely mirror, without going beyond, the statutory language of the Dodd-Frank Act, but give discretion to the exchanges to provide additional detail, restrictions and exemptions subject to the SEC’s approval of any proposed listing standards.

Independence

The SEC has proposed new Rule 10C-1 under the Exchange Act to implement the Dodd-Frank Act requirement for listing standards relating to compensation committees, which may require independence standards that are more rigorous than the exchanges’ current listing standards. While the Dodd-Frank Act requires that all members of a compensation committee be

directors and be independent, neither Section 10C of the Exchange Act nor proposed Rule 10C-1 defines independence. Tracking the statutory language of the Dodd-Frank Act, proposed Rule 10C-1 requires the exchanges to consider relevant factors when determining independence requirements for compensation committee, including, but not limited to:

- The source of a board member’s compensation, including any consulting, advisory or other compensatory fee paid by the issuer to such board member; and
- Whether a board member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The exchanges may also consider other factors in determining independence requirements, subject to the SEC’s approval process for exchange listing standards. The SEC did not include safe harbors for particular relationships in proposed Rule 10C-1.

Unlike the mandatory requirements of Rule 10A-3, which provide for enhanced independence standards for audit committee members, proposed Rule 10C-1 only requires the exchanges to *consider* the factors specified above in developing compensation committee independence standards. The exchanges are not required to preclude compensation committee membership where relationships described in the relevant factors exist. For example, the exchanges

will not be required to prohibit directors who represent holders of a large percentage of a company's shares from serving on compensation committees, although such significant investors may be affiliates of the company by virtue of their share holdings.

The SEC is leaving the details of compensation committee listing standards that are not expressly mandated by the Dodd-Frank Act to the exchanges to determine. In so doing, however, the SEC is requiring the exchanges to provide information beyond what is typically required when the exchanges submit rule changes to the SEC for approval. For example, in addition to setting forth the definition of independence that an exchange proposes to apply to compensation committee members, the exchange will have to review whether and how its existing listing standards satisfy the requirements of Rule 10C-1, and describe how the exchange considered factors relevant to compensation committee independence.

Proposed Rule 10C-1 addresses only current relationships between the issuer and the compensation committee member and does not mandate a "look-back" period for the required factors. However, the SEC has solicited comments on whether the required factors should also extend to a look-back period. Also, it is possible that a look-back could be added by an exchange when proposing its listing standards.

Listing standards to be adopted under proposed Rule 10C-1 must provide procedures that give listed companies the opportunity to cure defects. Proposed Rule 10C-1 allows such rules to provide that if a compensation committee member ceases to be independent for reasons outside of such director's reasonable control, the director will be permitted to remain a compensation committee member until the earlier of the company's next annual meeting or one year from the event that caused the member to no longer be independent. The listed company would be required to notify its exchange if it makes use of such rule.

Neither the Dodd-Frank Act nor proposed Rule 10C-1 requires any company to have a compensation committee. That requirement arises from applicable stock exchange listing standards. Therefore, if a public company is not listed on a stock exchange, or if it is listed on an exchange—such as Nasdaq—that permits executive compensation to be determined by a majority of the board's independent directors in a vote in which only independent directors participate (in lieu of a board committee), the Rule 10C-1 requirements will not apply. However, the Rule 10C-1 listing standards will apply to any committee that oversees executive compensation even if it performs multiple functions and is not formally designated as a "compensation committee."

Compensation Advisers

Like the Dodd-Frank Act, proposed Rule 10C-1 provides that the compensation committee of a listed issuer may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser. If so retained, the compensation committee is directly responsible for the appointment, compensation and oversight of such advisers. However, the compensation committee is not required to implement the recommendations of any such adviser, and the committee may exercise its own judgment in the fulfillment of its duties. The issuer must provide appropriate funding for such advisers, as determined by the compensation committee.

Under proposed Rule 10C-1, a compensation committee may only select a compensation consultant, legal counsel or other adviser after taking into consideration the following factors, as well as any other factors identified by the relevant exchange in its listing standards:

- The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;

- The amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser;
- The policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and
- Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser.

Exemptions

Proposed Rule 10C-1, like the corresponding Dodd-Frank Act provision, exempts the following from the compensation committee independence requirements:

- Controlled companies;
- Limited partnerships;
- Companies in bankruptcy proceedings;
- Open-end management investment companies registered under the Investment Company Act of 1940; and
- Any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee.

Exchanges may propose additional categories of issuers to be exempt from compensation committee listing standards, subject to the SEC's review. Proposed Rule 10C-1 also exempts listed security futures products and listed standardized options from its requirements.

Compensation Consultant Disclosure and Conflicts of Interest

The SEC has proposed an amendment to Item 407 of Regulation S-K that would integrate the Dodd-Frank Act disclosure requirements relating to compensation consultants and conflicts of interest with existing proxy statement compensation consultant disclosure requirements. The revised disclosure requirement will relate to all companies subject to the SEC's proxy rules, whether or not they are listed and without regard to whether they are controlled companies.

Amended Item 407 will require disclosure of whether the compensation committee has "retained or obtained" the advice of a compensation consultant during the previous fiscal year. An instruction to this item states that the compensation committee or management will be deemed to have "obtained the advice" of a compensation consultant if such committee or management has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant or a client relationship between the compensation consultant and the compensation committee or management or any payment of fees to the consultant for its advice.

Companies will have to disclose whether the compensation consultant's work raised any conflict of interest. If it did, the nature of the conflict of interest and how it is being addressed will have to be described. In determining whether a conflict of interest exists for disclosure purposes, companies should consider the same factors that the Dodd-Frank Act and proposed Rule 10C-1 require compensation committees to consider when hiring compensation consultants. For the purpose of consultant conflict of interest disclosure, there will not be a carve-out for advice on broad-based plans or the provision of non-customized benchmark data. These matters may be considered conflicts of interest that would

have to be described in the company's proxy statement.

Comments

Comments on the proposed release are due by April 29, 2011. Although the SEC stayed close to the Dodd-Frank Act requirements in its proposed release, and is providing a minimal comment period, it has asked for comments on quite a few questions, including whether:

- Compensation committee independence standards should apply to directors overseeing executive compensation without regard to whether there is a formal committee structure;
- Exchanges should require listed companies to have compensation committees without exception, similar to what exists today for audit committees;
- Rule 10C-1 should include additional relevant factors for consideration of compensation committee member independence;
- Rule 10C-1 should include additional compensation advisers independence factors;
- Rule 10C-1 should include materiality or numerical thresholds relating to compensation advisers' independence; and
- Foreign private issuers, registered management investment companies, newly public companies or smaller reporting companies should be exempted from the compensation committee listing standards.

Timing

Under the Dodd-Frank Act, the SEC must issue final listing standard rules by July 16, 2011. However, the Dodd-Frank Act did not specify when the exchanges must have new listing standards in effect. The SEC has proposed that the exchanges have 90 days after the SEC's final rule is published in the *Federal Register* to submit proposed listing standards to the SEC for approval. The SEC has proposed that the exchanges must have final listing standards that comply with the SEC's final rule not later than

one year after the SEC's final rule is published in the *Federal Register*. The compensation consultant conflict of interest disclosures will not be required before the effective date of the SEC's final rule.

Practical Considerations

- Because the SEC is proposing that the exchanges have one year from the publication of the SEC's final rule to have listing standards in place, there is no urgency for public companies to make changes to their compensation committee composition now. However, when companies perform their regular review of committee membership, which many companies do at the board meeting that follows the annual meeting of shareholders, they should consider the enhanced independence standards of the Dodd-Frank Act mandated rule when deciding who should serve on their compensation committees and should monitor the status of any stock exchange proposals when making future decisions.
- When hiring compensation consultants this year, companies should be aware that in proxy statements filed after the final SEC rule becomes effective, they may have to disclose as possible conflicts of interest any work that a consultant for the compensation committee performs during 2011 in connection with a company's broad-based compensation plans or in gathering non-customized survey data.
- The SEC is allowing a very short time frame for comments, so anyone wanting to submit comments needs to do so very quickly. However, the SEC did not venture far from the statutory provisions of the Dodd-Frank Act. With so much of the specifics being left to the exchanges to propose to the SEC in new or amended listing standards, it may be productive for a listed company to discuss particular issues that it finds of importance directly with its listing representative or with

the corporate governance specialists at the applicable exchange.

- Since the ultimate detail that goes beyond the specified the Dodd-Frank Act requirements will be in the applicable exchange listing standards rather than the SEC rule, it will be important to review the listing standards filings that the exchanges will make with the SEC.

Endnotes

¹ Release Nos. 33-9199; 34-64149, available at <http://www.sec.gov/rules/proposed/2011/33-9199.pdf>.

If you have any questions regarding the compensation committee listing standards and compensation consultant disclosure rules, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the lawyers listed below or any other member of our Corporate & Securities group.

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