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SEC Proposes Dodd-Frank Compensation Committee and Adviser Independence Rules

By David M. Lynn

Recently, the U.S. Securities and Exchange Commission (the “SEC”) proposed rules to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) that will potentially affect the composition of compensation committees and the use of compensation advisers by companies listed on national securities exchanges, as well as the disclosure provided by companies regarding their use of compensation consultants.¹ Under the rules as proposed, the national securities exchanges would be directed to adopt listing standards regarding the independence of the members of the compensation committee, as well as the independence of advisers engaged by the compensation committee. Moreover, the proposed rules would require additional disclosure under Item 407 of Regulation S-K regarding the retention of compensation consultants and any conflicts of interest raised by the work of compensation consultants. The SEC seeks public comment on these proposed rules by April 29, 2011. The Dodd-Frank Act specifies that the SEC’s rules must be adopted by July 16, 2011.

OVERVIEW

Section 952 of the Dodd-Frank Act added Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”). Section 10C requires that the SEC must direct the national securities exchanges and associations to prohibit the listing of any company issuing equity securities, subject to limited exceptions, unless specific conditions are satisfied with respect to the authority of the compensation committee, the independence of the members of the compensation committee, and the consideration of specific factors relating to the independence of compensation advisers (consultants, legal counsel and other advisers) retained by the compensation committee.

The SEC’s proposed rules, if adopted, would direct each of the national securities exchanges to develop their own listing standards that will implement these purposes of Section 952 of the Dodd-Frank Act. This approach is analogous to the implementation of corporate governance provisions of the Sarbanes-Oxley Act of 2002, which required the SEC to promulgate rules that directed national securities exchanges to adopt certain corporate governance exchange listing standards. The approach of using the SEC to direct the establishment of exchange listing standards is in recognition of the fact that the SEC’s oversight of public companies is principally with respect to required disclosures, while the national securities exchanges can impose conditions on substantive practices of public companies as a condition of listing.

The SEC has proposed Rule 10C-1 under the Section 10C of the Exchange to direct the national securities exchanges, including the New York Stock Exchange and Nasdaq, to adopt listing standards regarding compensation committees and the compensation advisers that they retain. Following adoption of the final rules by the SEC, the national securities exchanges will propose and adopt listing standards in accordance with the SEC’s final rules.²

¹ SEC Release No. 33-9199 (March 30, 2011), available at: <http://www.sec.gov/rules/proposed/2011/33-9199.pdf>.

² Because the Financial Industry Regulatory Authority (“FINRA”) is the only national securities association registered under the Exchange Act, the focus of the rulemaking is on the listing standards of the national securities exchanges. A “national securities exchange” is an exchange registered as such under Section 6 of the Exchange Act, and there are currently fifteen national securities exchanges registered under the Exchange Act. The national securities exchanges are referred to herein as “the exchanges.”

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Under proposed Rule 10C-1, the exchanges would be required to include the following in their listing standards:

- Each member of a compensation committee must be an independent member of the board of directors. Independence for the purposes of serving on the compensation committee is not specifically defined in the Dodd-Frank Act or the proposed rules, although the definition adopted by the exchanges must consider the following relevant factors: (1) the sources of compensation of the director, including any consulting, advisory or other compensatory fee paid by the company to the director, and (2) whether the director is affiliated with the company or any of its subsidiaries or their affiliates.
- The compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers (collectively, the “compensation advisers”), and must be directly responsible for appointing, compensating and providing oversight of the work of the compensation adviser. The company must provide appropriate funding (as determined by the compensation committee) for payment of reasonable compensation to compensation advisers.
- Compensation committees must consider certain independence criteria prior to hiring compensation advisers, including the following factors: (1) the provision of other services to the company by the firm employing the compensation adviser; (2) the amount of fees received from the company by the company employing the compensation adviser, as a percentage of that firm’s total revenue; (3) the policies and procedures adopted by the firm employing the compensation adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the compensation adviser with a member of the compensation committee; and (5) the compensation adviser’s ownership of the company’s stock.

In addition, the SEC proposes to amend its disclosure rules to require more proxy statement disclosures concerning the retention of compensation consultants, as directed by Section 952 of the Dodd-Frank Act. As proposed to be modified, the SEC rules would specify that, if a compensation committee retained or obtained the advice of a compensation consultant, the company would need to:

- identify the compensation consultant;
- state whether the consultant was engaged directly by the compensation committee (or another board committee performing equivalent functions);
- describe the nature and scope of the consultant’s assignment and the material elements of the instructions or directions given to the consultant with respect to the performance of the consultant’s duties under the engagement; and
- discuss whether the work of the consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

COMPENSATION COMMITTEE INDEPENDENCE LISTING STANDARDS

Under the SEC’s proposed rules, the exchanges would be directed to adopt listing standards that require each member of a compensation committee to be an independent member of the board of directors. Neither the Dodd-Frank Act nor the SEC’s proposed rules specifically define independence for this purpose, however, consistent with the Dodd-Frank Act, the national securities exchanges must consider:

- the sources of compensation of the director, including any consulting, advisory or other compensatory fee paid by the company to the director; and
- whether the director is affiliated with the company or any of its subsidiaries or their affiliates.

The SEC has proposed to provide the exchanges with more discretion in setting the definition of independence than is

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currently available with respect to the independence of audit committee members, as required pursuant to the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act").³ The SEC has not proposed any additional factors to be considered by the exchanges in establishing their listing standards. It is possible that the exchanges will consider and adopt additional relevant factors to be considered when determining if a compensation committee member is independent. The SEC is seeking comment on its approach to provide the exchanges with the discretion to determine the appropriate independence standards, and has asked whether additional mandatory factors should be included in the SEC's rules, such as business or personal relationships that compensation committee members have with management or significant shareholders. The SEC has also requested comment on whether a "look back" period should be specified with respect to the independence determination.⁴

COMPENSATION COMMITTEE AUTHORITY AND FUNDING

Proposed Rule 10C-1 would also direct the exchanges to prohibit the listing of a security of an issuer that is not in compliance with the following standards:

- The compensation committee, in its sole discretion, must have authority to obtain or retain the advice of compensation advisers;
- The compensation committee must be directly responsible for the appointment, retention, compensation and oversight of the work of any compensation advisers; and
- The issuer must provide the appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to the compensation advisers, if any.

The SEC makes clear that the proposed rules would not require that the compensation committee act in accordance with the advice of compensation advisers or otherwise affect the ability or obligation of the compensation committee to exercise its own judgment. Further, the proposed rules and the resulting listing standards are not intended to preclude the engagement of non-independent legal counsel or obtaining advice from in-house or outside counsel retained by the issuer or the issuer's management.

It is expected that, similar to the listing standards adopted following the Sarbanes-Oxley Act, the exchanges would require that the above-referenced authority and funding considerations be addressed in the charter for the compensation committee.

COMPENSATION ADVISER INDEPENDENCE

The proposed rule would direct the exchanges to adopt listing standards requiring that the compensation committee consider the independence factors specified in Section 10C, as well as any other relevant factors identified by the exchange, prior to engaging any compensation advisers. The independence criteria specified in Section 10C are:

- The provision of other services to the company by the firm employing the compensation adviser;

³ Section 301 of the Sarbanes-Oxley Act specifies that in order to be considered independent, a member of the audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other committee: (i) accept any consulting, advisory, or other compensatory fee from the company; or (ii) be an affiliated person of the company or any subsidiary thereof.

⁴ Companies may want to ensure that compensation committee members are independent for other purposes that may involve different standards, such as for the purpose of satisfying the conditions of Exchange Act Rule 16b-3(b) or to preserve the tax deductibility of certain compensation under Section 162(m) of the Internal Revenue Code.

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- The amount of fees received from the company by the company employing the compensation adviser, as a percentage of that firm's total revenue;
- The policies and procedures adopted by the firm employing the compensation adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation adviser with a member of the compensation committee; and
- The compensation adviser's ownership of the company's stock.

The SEC determined not to define or provide further clarification regarding any of these factors, and did not propose and other factors to be considered. The SEC is soliciting comment on whether any additional factors should be specified in the rule, and whether any particular considerations should be taken into account in determining, consistent with Section 10C, that a factor is competitively neutral.

EXEMPTIONS AND APPLICABILITY OF LISTING STANDARDS

In accordance with Section 10C, the listing standards requirements for compensation committee member independence and compensation committee adviser independence would not apply to controlled companies, issuers of securities futures products cleared by a registered clearing agency or a clearing agency exempt from registration, or registered clearing agencies that issue standardized options. Section 10C and the SEC's proposed rules also exempt the following categories of companies from the compensation committee member independence requirement:

- limited partnerships;
- companies in bankruptcy proceedings;
- open-end management investment companies registered under the Investment Company Act of 1940; and
- foreign private issuers that disclose annually why they do not have an independent compensation committee.

While Section 10C provides that the SEC's rules permit an exchange to exempt a particular relationship from the compensation committee independence requirements, the SEC did not propose to exempt any particular relationships at this time. The SEC indicates that it should be up to exchanges to make the determination of whether a particular relationship should be exempted. Section 10C also provides that the SEC's rules must permit the exchanges to exempt any category of issuers, taking into consideration the size of the issuer and other relevant factors that are deemed appropriate, subject to review by the SEC.

The SEC's rules as proposed would provide that the listing standards apply to any committee of the board overseeing a company's executive compensation, whether or not that committee is specifically designated as the compensation committee.

The proposed rules would provide a listed company with a reasonable opportunity to cure any compensation committee member independence issues prior to delisting after the new standards go into effect.

PROPOSED NEW DISCLOSURES

In accordance with Section 10C, the SEC is proposing to expand its current disclosure requirements regarding compensation consultants. The SEC proposes to amend Item 407 of Regulation S-K to specifically require disclosure of the retention of compensation consultants and conflicts with compensation consultants.

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Under the SEC's proposed amendments to Item 407, a company would be required to disclose whether the compensation committee has retained or obtained the advice of a compensation consultant during the last completed fiscal year, changing the current standard that disclosure is required as to whether compensation consultants played "any role" in the process for determining or recommending the amount or form of any executive or director compensation. For purposes of triggering this disclosure, a compensation committee would be considered to have "obtained the advice" of a compensation consultant if the committee or management has requested or received advice from the consultant, regardless of whether there is a formal engagement of the consultant or a client relationship between the consultant and the compensation committee or management or any payment of fees to the consultant for its advice.

Companies would also be required under the proposed amendments to Item 407 of Regulation S-K to disclose whether the work of the compensation consultant has raised any conflict of interest and, if so, provide a description of the nature of the conflict of interest and how it is being addressed. While the SEC has not proposed to define what would constitute a conflict of interest, the proposed rule would provide that the same five factors for considering consultant independence under Section 10C should be considered in determining whether a conflict of interest exists.

In addition, as is presently the case, to the extent that a compensation consultant that is advising the compensation committee or management on executive or director compensation matters also provides additional services in excess of \$120,000 during the company's last completed fiscal year, then the company would need to disclose the aggregate fees for the executive or director compensation-related services and the aggregate fees for the additional services.

The proposed expanded disclosures required by Item 407 of Regulation S-K would continue to apply for disclosures in proxy statements and information statements for annual meetings, or special meetings in lieu of an annual meeting, at which directors are elected.

MOVING FORWARD

Once the SEC has adopted final rules, the exchanges will have 90 days from the publication of the final rules in the Federal Register to propose listing standards contemplated by Section 10C and the SEC's rules. The proposed listing standards will be subject to further public comment, and must be adopted by the SEC no later than one year after the SEC's final rules are published in the Federal Register.

The expanded SEC disclosure requirements will apply to proxy or information statements filed on or after July 21, 2011, assuming that the SEC's final rules will be adopted by that date.

It is expected that the SEC and the exchanges will work together on adopting the final listing standards in the second half of 2011. As with the adoption of corporate governance listing standards following the Sarbanes-Oxley Act, it is expected that the SEC will endeavor to encourage as much uniformity as possible in the listing standards adopted by the various exchanges.

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