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SEC Proposes Rules for Compensation Committee and Adviser Independence

On March 30, 2011, the Securities and Exchange Commission issued proposed rules as the next step in implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Act”). Section 952 contains several related requirements:

- Compensation committee (“Committee”) members shall be independent;
- A Committee may only select an adviser (e.g., compensation consultant; legal counsel) after considering certain factors that bear on the independence of the adviser;
- The Committee shall have sole discretion to retain the adviser and the issuer shall be responsible for providing appropriate funding; and
- The issuer’s proxy statement shall disclose whether the Committee used a compensation consultant and, if so, whether any conflict of interest was raised and how it was resolved.

Despite the length of the proposed rules and their accompanying commentary, there are very few differences from the statutory language. In part, this stems from the SEC’s decision to leave the primary responsibility for detailed rule making to the individual securities exchanges; accordingly, rules by the NYSE may be the key document in determining how the new Committee independence rules apply to companies listed on the NYSE.

With respect to timing, comments on the SEC’s proposed rules are due by April 29, 2011. The Act requires final SEC rules by July 16, 2011. The SEC’s proposed rules provide 90 days after the final SEC rules for the securities exchanges to issue proposed rules for SEC approval (which the SEC must approve) and one year after final SEC rules for the securities exchanges to issue final rules. The upshot of this timing is that final rules of the securities exchanges might not be in effect before July 16, 2012. New disclosure rules apply, however, to definitive proxy statements filed on or after the date the SEC publishes final rules.

Committee Independence

Section 952 of the Act prohibits the listing of an equity security by a securities exchange unless the Committee members meet certain independence standards. While the statute lists several factors to be taken into account in determining independence, it provides that the actual rules shall be issued by the securities exchanges.

With one exception (described below), the proposed rules do little to elaborate upon the statutory criteria, which list the following as independence factors:

- The source of compensation of a member of the board of directors (including consulting, advisory, or other compensatory fees paid by the issuer); and
- Whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

Since the SEC's rules leave the concrete guidance to the securities exchanges, there may be little to do until the securities exchange rules are issued, especially because the proposed rules require issuers to have a "reasonable opportunity to cure defects" in complying with Section 952, and the proposed rules indicate that the cure period may last up to one year if a Committee member ceases to be independent for reasons outside his or her control (for example, the issuer acquires a company where the director is an executive officer).

There is new SEC guidance in one area. Section 952 exempts from its requirements issuers where more than 50% of the stock is owned by one person or entity. Concern had been expressed in comments the SEC received on Section 952 over whether a representative of a controlling shareholder that was not a more-than-50% shareholder might be precluded from serving on the Committee, especially in light of the fact that the audit committee independence requirements do preclude affiliates of controlling shareholders from serving on the audit committee. However, the SEC noted several differences between the rules regulating audit committee independence and compensation committee independence in its discussion of the proposed rules and concluded that the securities exchanges have the authority to provide that representatives of controlling shareholders could serve on compensation committees.

Under the statute, the Committee independence rules do not apply to several categories of issuers even if they are registered under the Exchange Act. In particular, they do not apply if an issuer's equity securities are only traded over the counter through the OTC Bulletin Board or the OTC Markets Group. As mentioned above, there are exemptions from the Committee independence rules for controlled companies (one person or entity owns more than 50% of voting stock), limited partnerships, companies in bankruptcy, open-end management investment companies registered under the Investment Company Act, and foreign private issuers (if the issuer explains in its annual report the reasons that it does not have an independent Committee). In addition, the securities exchanges are given general exemptive authority, though the proposed regulations contain no specific direction on how that authority is to be exercised.

Adviser Selection, Independence, and Proxy Disclosure Rules

Neither the SEC's proposed rules nor the accompanying commentary elaborate very much on the statutory language regarding consultant independence. This statutory language is described in our letter of June 29, 2010, "Executive Compensation and Corporate Governance Provisions in Dodd-Frank Bill."¹ It appears that, once again, the SEC's approach is to give the securities

¹ http://www.fwcook.com/alert_letters/06-29-

[10_Executive_Compensation_and_Corporate_Governance_Provisions_in_Dodd-Frank_Bill.pdf](#)

exchanges authority to elaborate on these rules. It is important to note that, unlike the Committee independence standards, the adviser independence standards are not factors that must be met, but factors that must be taken into account by the Committee in selecting its advisers. The proposed regulations repeat the five factors listed in the statute: (1) the provision of other services to the issuer by the person that employs the adviser ; (2) the amount of fees provided by the issuer to the person that employs the adviser as a percentage of total revenues; (3) the policies and procedures that the person that employs the adviser has in place to prevent conflicts of interest; (4) any business or personal relationships between the adviser and any member of the Committee; and (5) whether any of the issuer's stock is owned by the adviser.

The SEC specifically notes that the securities exchanges are free to develop additional independence factors for issuers to take into account, so it will be important to monitor the content of the proposed securities exchange rules.

The SEC's proposed proxy disclosure rules require issuers to disclose whether the Committee retained or obtained the advice of a compensation consultant, whether the resulting work has raised any conflict of interest (and the nature of the conflict), and how any such conflict is being addressed. The proposed rules are largely consistent with the current rules, but they are slightly broader in that there will no longer be an exception from the consultant disclosure requirement when the consultant only provides advice on broad-based plans or non-customized benchmarking data. In the interest of developing one set of uniform rules, these modified rules apply to all Exchange Act reporting companies even though some of them, such as controlled companies and unlisted reporting companies, are not subject to Section 952.

Also, although the Committee independence standards do not apply to foreign private issuers that disclose the reasons why they do not have independent Committees in their annual reports, these issuers will be subject to the requirement that the Committee consider the independence of consultants and other advisers.

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice. General questions about the subjects in this letter may be directed to Alexa Kierzkowski at 310-734-0110 (ahkierzkowski@fwcook.com) or David Gordon at 310-734-0111 (degordon@fwcook.com). Copies of this letter and other published materials are available on our website at www.fwcook.com.