

# SEC Initiates Rulemaking for Compensation Committee/Committee Adviser Independence Standards

**A**mong its various executive compensation provisions, the Dodd-Frank Act requires the Securities and Exchange Commission and the national securities exchanges to strengthen the independence of board compensation committees and to require such committees to assess the independence of any compensation consultant, legal counsel, or other adviser before engaging them. The Dodd-Frank Act also directs the SEC to adopt new disclosure rules concerning the identity and engagement of compensation consultants by a company.

On March 30, 2011, the SEC initiated this rulemaking process, proposing rules that will direct the national securities exchanges to amend their listing standards so that public

companies must satisfy these new independence requirements to maintain their listing status. This project is on a fast track, as the SEC must complete its rulemaking by July 16, 2011. Consequently, comments on the proposed rules must be submitted to the Commission by April 29, 2011.

## Background

To provide greater assurances as to the integrity of the executive compensation-setting process, Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added new Section 10C to the Securities Exchange Act of 1934.

Section 10C requires the SEC to direct the national securities exchanges to prohibit the listing of any company

## Five Things You Should Know about the SEC's Proposed Rules on Compensation Committee/Committee Adviser Independence

- ▶ The proposed rules do not elaborate on the "independence" factors (set forth below) which are specified in Section 952 of the Dodd-Frank Act. Surprisingly, the SEC has delegated responsibility for explaining (and possibly supplementing) these factors to the national securities exchanges (that is, the NYSE, the Nasdaq, and the AMEX).
- ▶ The national securities exchanges must modify their listing standards to require that the members of the board compensation committee of listed companies be directors and meet specific independence standards which take into consideration the source of the compensation received by a director, including any consulting fees, and whether the director is affiliated with the company.
- ▶ The national securities exchanges must also modify their listing standards to require that the board compensation committees of listed companies consider the independence of a potential adviser to the committee (such as a compensation consultant or legal counsel) before engaging such adviser. Notably, board compensation committees are not required to use independent advisers.
- ▶ The proposed rules would require all companies (not just listed companies) to disclose in their proxy statement the identity of any compensation consultant retained by the board compensation committee, whether the engagement created any potential conflict of interest, and, if so, how the conflict was resolved.
- ▶ While the SEC must complete its rulemaking by July 16, 2011, the national securities would have up to one year from the completion of this rulemaking to have the revisions to their listing standards approved by the SEC. Consequently, it's not yet clear when the new independence requirements will become effective (and, accordingly, how long listed companies will have to bring the composition of their board compensation committees into compliance). The new SEC disclosure requirements will go into effect on July 21, 2011 or the date the SEC rules are effective, if later.

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issuing equity securities (with limited exceptions, including controlled companies and certain foreign private issuers) unless:

- All of the members of its board compensation committee are directors and meet specific independence standards.
  - ▶ For this purpose, “independence” is to take into consideration the source of compensation received by a director, including any consulting fees, and whether the director is affiliated with the company, any subsidiary of the company, or an affiliate of any subsidiary.
- Before selecting a compensation consultant, legal counsel, or other adviser, the board compensation committee takes into consideration factors that affect such prospective adviser’s independence. These factors, which are to be competitively neutral, must include:
  - ▶ Whether the firm that employs the compensation consultant, legal counsel, or other adviser provides any other services to the company;
  - ▶ The amount of fees received from the company by the firm that employs the compensation consultant, legal counsel, or other adviser as a percentage of that firm’s total revenue;
  - ▶ The policies and procedures of the firm 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 company owned by the compensation consultant, legal counsel, or other adviser.

As noted, these factors distinguish between the individual providing advice to the board compensation committee and the firm that employs the individual.

Section 10C also requires companies to disclose in their annual proxy statements, on or after July 21, 2011, whether the board compensation committee has engaged a compensation consultant, whether the consultant’s work has raised any conflict of interest, and, if so, the nature of the conflict and how it was resolved.

Finally, Section 10C confirms the authority of the board compensation committee to retain and oversee the work of a compensation consultant, legal counsel, and other adviser and directs companies to provide appropriate funding for these engagements. The provision also grants the national securities exchanges the authority to exempt certain categories of companies, including smaller reporting companies, from these requirements.

### The SEC’s Proposed Rules

On March 30, 2011, the Securities and Exchange Commission proposed rules directing the national securities exchanges to begin the process of revising their listing standards to reflect the independence requirements of new Section 10C.

### Compensation Committee Independence

The proposed rules would instruct each of the national securities exchanges to develop listing standards that require all of the members of the board compensation committee (or committee performing equivalent functions) to be independent, as determined by the exchange. The exchange would be free to consider any relevant factors in formulating its “independence” definition as long as these factors included the source of compensation received by a director, including any consulting fees, and whether the director is affiliated with the company, any subsidiary of the company, or an affiliate of any subsidiary; the two factors expressly prescribed by the Dodd-Frank Act.

Under the proposed rules (as under the Dodd-Frank Act), controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended 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 would be exempt from the compensation committee independence requirement. The proposed rules would also grant the national securities exchanges the authority to exempt particular relationships that may exist with respect to compensation committee members of smaller reporting companies.

The proposed rules incorporate the Dodd-Frank Act provision that would give a company a reasonable opportunity to reconstitute its board compensation committee before a

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delisting because of a failure to satisfy this new requirement could go into effect.

**Observations.** While, at this point, it is difficult to predict how the national securities exchanges will define “independence,” the formulation will be particularly important to directors who represent shareholders that are affiliates of a company, such as venture capital or private equity investors. Depending on the wording of the required definitions, such directors may not be permitted to serve on the board compensation committee.

### Compensation Committee Adviser Independence

The proposed rules would instruct each of the national securities exchanges to develop listing standards that require a board compensation committee to consider the five “independence” factors specified in Section 10C, as well as any other factors identified by the exchange, before engaging a compensation consultant, legal counsel, or other adviser to assist on compensation-related matters. Interestingly, the proposed rules do not elaborate on the meaning or scope of the five enumerated factors or provide any additional factors to be considered. Presumably, this work is being left to the exchanges.

Under the proposed rules, the national securities exchanges would also have the authority to exempt certain categories of companies, such as smaller reporting companies, from this independence assessment requirement.

**Observations.** Consistent with Section 10C, the proposed rules make clear that board compensation committees are free to engage compensation consultants, legal counsel, and other advisers as they see fit, as long as they have considered any potential conflict of interest and taken steps to minimize any potential conflict in advance. Thus, the Dodd-Frank Act and the related rules leave to a company – and its shareholders – the decision on whether a compensation consultant, legal counsel, or other adviser is an appropriate adviser to the board compensation committee.

As for the factors that are to be considered in evaluating the independence of a compensation consultant, legal counsel, or other adviser, it will be up to the national securities exchanges to determine how they are to be applied. Presumably, the public will be given an opportunity to comment on the proposed scope of these factors before they are approved. For example, we expect that the exchanges are likely to clarify that “business or personal relationships”

do not include situations where a compensation committee member serves on the compensation committee of a second company that has engaged the compensation consultant being evaluated.

### Compensation Consultant Disclosure

The proposed rules would implement the new disclosure requirements of Section 10C. Specifically, beginning on or after July 16, 2011, any proxy statement filed for an annual meeting of shareholders would need to identify any compensation consultant engaged by the board compensation committee and discuss whether the consultant’s work raised any conflict of interest and, if so, the nature of the conflict and how it was addressed.

Unlike the other proposed rules, this rule would apply to all companies, not just listed companies. In addition, it would apply to controlled companies.

**Observations.** The SEC is proposing to integrate this new disclosure requirement with its existing requirements that companies disclose their use of compensation consultants and provide detailed fee information where a consultant provides both compensation-related services and non-compensation-related services to the board compensation committee or the company. As a result, if the proposed rules are adopted in their current form, they will make two subtle changes to the current disclosure regime:

- Disclosure would be required when the board compensation committee retains or obtains the advice of a compensation consultant. Currently, disclosure is required if a consultant plays “any role . . . in determining or recommending the amount or form of executive and director compensation.”
- The current disclosure exemption for work that is limited solely to consulting on any broad-based, non-discriminatory compensation plan or providing information that is not customized for the client-company would be eliminated.

### Exemptions

Consistent with new Section 10C, the listing standard requirements for compensation committee independence and compensation committee adviser independence would not apply to controlled companies, issuers of securities futures products cleared by a registered clearing agency or

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a clearing agency exempt from registration, or registered clearing agencies that issue standardized options.

### Next Steps

The public comment period on the proposed rules runs through April 29, 2011.

### Listing Standards

Although the Dodd-Frank Act requires the SEC to adopt final rules by July 16, 2011, there is no statutory deadline for the national securities exchanges to act. Instead, the proposed rules would require the national securities exchanges to:

- submit their proposed listing standards to the SEC within 90 days of the date that the final SEC rules are published in the Federal Register, and
- have their proposed listing standards approved by the SEC no later than one year after the final SEC rules are published in the Federal Register.

While these deadlines are sufficiently flexible that it is possible that the revised listing standards could become effective later this year, we are probably still a few months away

from being able to predict whether the standards will be applicable this year or in 2012.

### Disclosure Requirements

The new SEC disclosure requirements will apply to proxy statements filed on or after July 21, 2011, the one year anniversary of the enactment of the Dodd-Frank Act (assuming that the final SEC rules implementing this requirement are in effect by that date).

### Compensia's Commitment to Our Clients

We recognize that the value and integrity of our client's executive compensation actions and decisions are dependent on the board compensation committee having access to candid, impartial advice and analysis provided by an adviser that is free from any conflicts of interest. As a trusted adviser to board compensation committees, we strive to ensure that our services are conducted in an impartial and objective manner. In furtherance of this commitment, we maintain internal policies and practices designed to safeguard our independence. ■

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## About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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