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Client**Alert**

Financial Markets Developments

Capital Markets/Securities
Employment & Benefits
April 2011

SEC Proposes Compensation Committee and Compensation Adviser Independence Rules as Required by the Dodd-Frank Act

On March 30, 2011, the Securities and Exchange Commission (the "SEC") proposed rules that would begin the process of implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The proposed rules direct the national securities exchanges to adopt listing standards relating to the independence of compensation committee members, the compensation committee's authority to retain compensation advisers and the compensation committee's responsibility for the appointment, compensation and work of any compensation adviser. In addition, the SEC also proposed amendments to Item 407(e)(3) of Regulation S-K that would require disclosure in annual proxy materials of whether a compensation committee has retained or obtained the advice of a compensation consultant, whether the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Comments on the proposed rules are due by April 29, 2011. After final rules are adopted, the national securities exchanges will still have to publish implementing rules which will themselves be subject to review and comment. The SEC has set July 16, 2012 as the outside date by which national securities exchanges should have effective rules implementing Section 952.

Compensation Committee Independence Requirements

Proposed Rule 10C-1 under the Securities Exchange Act of 1934 (the "Exchange Act") directs each national securities exchange to establish listing standards requiring that each member of a listed company's compensation committee be a member of the company's board of directors and be independent under an independence definition to be developed by the national securities exchanges. Proposed Rule 10C-1 and the proposing release provide helpful indicators as to the rules the national securities exchanges might adopt.

First, the SEC clarifies that the independence requirements for audit committee members contained in Section 301 of the Sarbanes-Oxley Act of 2002, implemented through Rule 10A-3 under the Exchange Act, are fundamentally different from the independence requirements of Section 952 of the Dodd-Frank Act. Section 301 requires the national securities exchanges to promulgate rules prohibiting persons who are affiliates of the issuer or a subsidiary, or receive compensation from the issuer, from serving on the audit committee. Conversely, Section 952 merely directs the national securities exchanges to "consider" enumerated relevant factors when promulgating rules. As a result, the SEC's

1 For a detailed discussion of the corporate governance and executive compensation provisions of the Dodd-Frank Act, refer to our July 2010 Client Alert *Corporate Governance and Executive Compensation Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*.

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proposed rules do not establish independence standards, but instead direct the exchanges to consider any relevant factors including, but not limited to:

- the source of compensation of a director (including consulting, advisory, or any other compensatory fees paid); and
- whether a director is affiliated with the company, a subsidiary of the company, or an affiliate of the subsidiary of the company.

Based on the above framework, the SEC stated expressly in the proposing release that an exchange may determine that a director who is affiliated with a company by virtue of a relationship with a significant shareholder *can* serve on the compensation committee. Assuming the national securities exchanges embrace this guidance, the outcome will be welcomed by investors such as private equity and venture capital funds that often hold significant stakes in public companies.

Second, when the exchanges propose their new independence standards for SEC approval, the SEC is expressly requiring them to review whether existing listing standards satisfy the requirements of Rule 10C-1. In doing so, the SEC is recognizing that existing compensation committee independence requirements may be sufficient to satisfy Section 952 with relatively few changes. One area the exchanges will need to consider is whether to mirror the outright prohibition of compensation that exists for audit committee members compared to the US$120,000 annual limit, with a three-year look-back, provided for by current exchange rules.[2]

Finally, while the new rules offer the possibility that the definition of independence for compensation committee members may remain the same as the current definition of independence, companies will still need to consider the definition of "outside director" under Section 162(m) of the Internal Revenue Code (i.e., in order to preserve the tax-deductibility of performance-based compensation in excess of US$1 million for certain named executive officers) and the definition of "non-employee director" under Section 16 of the Exchange Act (i.e., for the purpose of exempting equity awards from short-swing profit rules). It is unfortunate that Congress did not harmonize standards across all legislation.

Compensation Committee Advisers

Authority to Engage Advisers

Proposed Rule 10C-1 directs each national securities exchange to establish listing standards providing that (1) compensation committees may engage a compensation consultant and other independent advisers, including independent legal counsel, (2) the compensation committee must be directly responsible for the appointment, compensation and oversight of the work of a compensation consultant or other adviser, and (3) each listed company is required to provide appropriate funding for payment of reasonable compensation to a compensation consultant or other adviser.

It should be noted that the Dodd-Frank Act does not actually require that a compensation committee's adviser be independent. The proposing release confirms that the proposed rules should not be construed "as requiring a compensation committee to retain independent legal counsel or as precluding a compensation committee from retaining non-independent legal counsel or obtaining advice from in-house counsel or outside counsel retained by the issuer or management."

The clear trend among larger public companies is for compensation committees to engage their own compensation consultant who does not provide services to the company or its management with respect to compensation. Conversely, at this point, only a minority of compensation committees have engaged counsel separate from the company's regular outside corporate counsel. It will be difficult for companies to engage large firms for the purpose of advising solely the compensation committee if that engagement precludes the firm from working on other company matters. It also remains to be seen if compensation committees believe they need independent counsel. We expect that most will not.

Independence of Advisers

Proposed Rule 10C-1 directs each national securities exchange to establish listing standards providing that compensation committees must consider certain factors relating to the independence of compensation consultants, legal counsel and other advisers, including:

(1) whether the entity employing the compensation consultant, legal counsel or other adviser provides other services to the company;

(2) the amount of fees received from the company by the entity employing the compensation consultant, legal counsel or other adviser as a percentage of the total revenue of that entity;

(3) the policies and procedures of the entity employing the compensation consultant, legal counsel or other adviser designed to prevent conflicts of interest;

2 NYSE Listed Company Manual 303A.02 and NASDAQ Listing Rule 5605(c).

(4) any business or personal relationship between the compensation consultant, legal counsel or other adviser and a member of the compensation committee; and

(5) whether the compensation consultant, legal counsel or other adviser owns any stock in the company.

National securities exchanges may also adopt in their rules additional independence factors deemed relevant by the exchange; however, those additional factors cannot add materiality or bright-line thresholds or cutoffs to the factors listed above.

The SEC has solicited comment on a wide range of matters related to the independence of compensation committee advisers. One request solicits comment on whether the SEC should amend Regulation S-K to require listed issuers to describe how the compensation committee implemented the above factors in its selection process.

Once the exchanges have promulgated their independence rules, compensation committees will have to evaluate their existing adviser relationships to determine whether they satisfy the new independence requirements and review compensation committee charters to ensure that they contain provisions regarding authority to retain compensation consultants and other advisers and set forth a process for evaluating independence of such advisers in accordance with the exchange listing standards.

Applicability

The proposed rules would apply to a listed company's compensation committee or, if the company does not have a compensation committee, to a committee that performs the functions typically performed by a compensation committee. It should be noted that, while New York Stock Exchange rules require an independent compensation committee, NASDAQ Stock Market Rules permit executive compensation to be determined or recommended by a majority of the board's independent directors, in a vote in which only independent directors participate. Nevertheless, the proposed rules do not mandate securities exchanges to require listed companies to have a compensation committee (although the SEC has solicited comment on whether national securities exchanges should impose this requirement) or to have executive compensation approved by independent directors. Although the proposed rule would not apply to a NASDAQ-listed company that has neither a compensation committee nor another committee that oversees compensation, this is of limited practical significance, as most NASDAQ-listed companies have a compensation committee or other committee that oversees compensation.

Exemptions

Proposed Rule 10C-1 would exempt the following companies from its provisions:

	Compensation Committee Member Independence Requirements	**Authority of Compensation Committee to Engage Independent Compensation Consultant and Other Advisers**
Controlled company[3]	Exempt	Exempt
Foreign private issuer[4] that discloses in its annual report the reasons why it does not have an independent compensation committee	Exempt	Not exempt
Limited partnerships	Exempt	Not exempt
Companies in bankruptcy proceedings	Exempt	Not exempt
Open-end management investment companies registered under the Investment Company Act of 1940 (i.e., mutual funds)	Exempt	Not exempt

As proposed, any foreign private issuer can opt out of the independence requirements of Rule 10C-1 if it opts out of the requirement to have an independent compensation committee under the rules of a national securities exchange. It is to be expected that foreign private issuers will take advantage of this opt-out option if the final independence rules are onerous. However, if as noted above, those rules ultimately track existing requirements and a foreign private issuer already follows such requirements, there will be little reason for a foreign private issuer

3 A "controlled company" is a company in which more than 50 percent of the voting power is held by an individual, a group or another issuer.

4 A "foreign private issuer" is any foreign issuer other than a foreign government except for an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter: (1) more than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and (2) any of the following: (i) a majority of the executive officers or directors are United States citizens or residents; (ii) more than 50 percent of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.

to opt out. It should be noted that foreign private issuers with a compensation committee cannot opt out of the requirement that such compensation committee have the authority to engage an independent compensation consultant and other advisers.

In addition to the above general exemptions, the SEC would allow the exchanges to propose other exemptions to their listing standards. In doing so, the exchanges are explicitly directed to take into account the potential impact on smaller reporting issuers. As with all listing standards, the exchanges would need to seek the approval of the SEC before adopting any exemptions.

Disclosure Requirements

Item 407(e)(3) of Regulation S-K currently requires registrants to disclose, in connection with an annual meeting (or special meeting in lieu of an annual meeting), "any role of the compensation consultants in determining or recommending the amount or form of executive and director compensation."

Under Item 407(e)(3) as proposed to be amended, a company would be required to disclose whether its compensation committee retained or obtained the advice of a compensation consultant (i.e., rather than formally "engaged" one); to identify the compensation consultant; to state whether the consultant was engaged directly by the compensation committee (or another board committee performing equivalent functions); and to 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. 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, a relationship with the compensation committee or management, or any payment of fees.

Amended Item 407(e)(3) would also require specific discussion on whether the work of the consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict has been addressed. A general description of the company's policies and procedures on conflicts of interest would not suffice. The proposed rules do not specifically define what conflict of interest would trigger a disclosure obligation; however, the same five factors that are to be considered in evaluating the independence of compensation consultants are also to be considered in evaluating whether a conflict of interest exists.

The proposed rules would eliminate the current exception and require disclosure about the compensation consultant even if the consultant provides only advice on broad-based plans or provides only non-customized benchmark data. In this regard, the proposed rules would broaden the scope of disclosure currently required by Item 407(e)(3). Fee disclosure requirements would remain the same.

The new disclosure requirement would apply to all companies subject to the SEC's proxy rules, including companies that are not listed and controlled companies—not just companies listed on a national securities exchange. As such, the proposed rules are broader than Dodd-Frank Act's requirements.

Timing

Section 952 of the Dodd-Frank Act requires the SEC to act within 360 days of the effective date of the Dodd-Frank Act (i.e., by July 16, 2011). Comments on the proposed rules are due to the SEC by April 29, 2011. Further, while Section 952 does not impose a specific deadline for the listing standards developed by the national securities exchanges to be effective, the proposed rules would require the national securities exchanges to provide the SEC their proposed rules no later than 90 days after the final version of the rules is published in the Federal Register and each national securities exchange would be required to have final rules in place no later than one year after the final version of the rules is published in the Federal Register (i.e., July 16, 2012 assuming that the final rules are published on the statutorily imposed deadline). Practically speaking, the proposed timing requirements make it unlikely that the new rules will be effective for the 2012 reporting season.