

Final Rules from the SEC Coming Soon – Compensation Committee Member Independence and the Use of Independent Compensation Consultants

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On March 30, 2011, the Securities and Exchange Commission (the "SEC") proposed rules to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Section 952 of the Act amended the Securities Exchange Act of 1934 by adding Section 10C, which directs the SEC and the U.S. securities exchanges and associations (the "national exchanges") to enact laws concerning the independence of an issuer's compensation committee. Subject to limited exceptions, the proposed rules and the Act prohibit the national exchanges from listing any equity security of an issuer that does not comply with the requirements of Section 10C.

The proposed rules, discussed below, would require that:

1. each member of a compensation committee meet a new standard of "independence" to be defined by the national exchanges;
2. a compensation committee be empowered to retain, compensate and oversee outside compensation consultants, legal counsel and other advisers ("compensation advisers"); and
3. an issuer must disclose if it "retained or obtained" a compensation consultant during the issuer's last completed fiscal year.

The SEC's extended comment period of the proposed rules expired May 19, 2011. The final rules are expected to be issued by the SEC this summer. For a comprehensive review of Section 952 and the other provisions of the Act, please see our Summer 2010 issue of the Corporate Communicator.

Independence of Compensation Committee Members

How Does a Board Determine Who is an "Independent" Compensation Committee Member?

Akin to the Sarbanes-Oxley Act of 2002, heightened independence requirements for audit committee members and their advisers, the proposed rules would require that each board member of a compensation committee meet a heightened standard of "independence." This new definition of independence applicable to compensation committee members and compensation advisers will be defined and implemented by the national

exchanges. The Act requires the national exchanges to consider the following two factors when defining "independence:"

1. the source of compensation of the compensation committee member, including any consulting, advisory or other compensatory fee paid by the issuer; and
2. whether the member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of the issuer.

The heightened definition of independence would apply to the members of the issuer's compensation committee or, if no such committee exists, any other independent board committee overseeing executive compensation or performing the functions normally executed by a compensation committee. The required independence of non-compensation committee members performing compensation committee functions is probably more of a practical concern for issuers trading on NASDAQ and other public exchanges that do not require the existence of a compensation committee.

What Happens if a Compensation Committee Member Ceases to be "Independent?"

The proposed rules would require the national exchanges to establish procedures that provide an issuer with a "reasonable opportunity" to cure any independence-related defect prior to delisting the issuer from a national exchange. The proposed rules also allow a compensation committee member, who is no longer independent for reasons outside the member's control, to remain on the compensation committee until the earlier of one year from the event that resulted in non-compliance or the next annual meeting of the issuer. We expect the criteria for what qualifies as "outside the member's control" to be stringent and limited.

Independence Requirements for the Retention of Compensation Advisers; Additional Disclosures Related to Compensation Consultants

How Do Issuers Determine if a Compensation Adviser is "Independent?"

The proposed rules (to be implemented through each national exchange's listing standards) provide that the compensation committee may, in its sole discretion, engage, compensate and oversee independent compensation advisers. While the proposed rules do not require a compensation adviser to be independent, the proposed rules do require that a compensation committee must consider five factors in assessing the independence of a

potential compensation adviser and the independence of the potential compensation adviser's employer. It is important to note that these factors may not be exhaustive as the proposed rules allow the national exchanges to specify additional factors for a compensation committee's consideration. The proposed rules require a compensation committee to consider the following factors:

1. whether the employer of the compensation adviser provides other services to the issuer;
2. the amount of fees received from the issuer by the employer of the compensation adviser as a percentage of its total revenue;
3. the policies and procedures of the compensation adviser's employer 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. whether the compensation adviser owns any stock of the issuer.

Issuers are required to provide adequate funding for the compensation committee's utilization of compensation advisers. The compensation committee must employ its own judgment in fulfilling its duties and is not required to follow the advice or recommendations of its compensation advisers.

What Disclosure Obligations Does an Issuer Have with Regard to its Compensation Consultants?

The proposed rules would require additional disclosure by an issuer related to its compensation consultants (versus the broader group of compensation "advisers") in its proxy or information statement for an annual meeting. Currently, Item 407(e)(3) of Regulation S-K requires the disclosure of "any role" a compensation consultant has in recommending the amount or form of executive and director compensation. The proposed rules would amend Item 407(e)(3) to:

1. require the issuer to disclose when the compensation committee "retained or obtained" the advice of a compensation consultant during the issuer's last completed fiscal year (compared to the "any role" standard under the current Item 407(e)(3));
2. broaden Item 407(e)(3) by eliminating the current disclosure exemption for consultants who advise solely on broad-based plans that do not discriminate in scope, terms or operation in favor of executive officers or directors of the issuer and that are available generally to all salaried employees; and

3. require an issuer to disclose whether any conflicts of interest arose during the engagement, and, if so, the nature of the conflict of interest and how the issuer is addressing the conflict of interest (current Item 407(e)(3) contains various exemptions to this disclosure requirement).

The SEC's proposed instructions to Item 407(e)(3) would require an issuer to consider the five "independence" factors listed above when determining whether a conflict of interest exists that needs to be disclosed in response to the amended Item 407(e)(3).

Exemptions to the Proposed Rules

The proposed rules allow the national exchanges to exempt certain categories of issuers as they deem appropriate from the revised listing standard requirements related to compensation committee member independence, the independence of compensation advisers and the compensation committee's authority to retain, compensate and oversee compensation advisers.

The proposed rules would exempt the following types of listed companies from *all* new listing standards: (1) controlled companies, (2) issuers of securities futures products cleared by a registered clearing agency or a clearing agency exempt from registration and (3) registered clearing agencies that issue standardized options. For purposes of the proposed rules, a "controlled company" is any listed issuer of which more than 50 percent of the voting power is held by an individual, a group or another issuer.

In addition to the three exemptions listed above, the following categories of listed issuers are not subject to the heightened independence requirements for compensation committee members:

1. limited partnerships;
2. issuers in bankruptcy proceedings;
3. open-ended management investment companies registered under the Investment Company Act of 1940; and
4. foreign private issuers that provide annual disclosure to shareholders of the reasons why the foreign private issuer does not have an independent compensation committee.

Under the proposed rules, the national exchanges are permitted to implement rules that exempt certain relationships with committee members

from the independence requirements if the national exchanges deem it appropriate based on the size of the issuer.

What Issuers Should Expect and Accomplish in the Months Ahead

As noted above, the SEC expects to issue final rules by this summer. The national exchanges are required to provide the SEC with their proposed rules or rule amendments within 90 days after publication of the SEC's final rules. Each national exchange's proposed rules or rule amendments must be approved by the SEC within one year after publication of the SEC's final rules. It is unclear at this point whether the new listing standards will be in effect for the 2012 proxy season.

Moving forward, companies should carefully review their existing internal "independence" determinations regarding past, current or future members on the compensation committee or a committee performing similar functions. After the issuance of the final rules, each listed company should consider:

1. reviewing and tracking all sources of committee member compensation and each member's relationships with other members of the board and third parties for potential conflicts of interest;
2. reviewing its current "retained or obtained" compensation advisers for purposes of evaluating if those engagements trigger disclosure requirements;
3. reviewing its compensation committee charter, bylaws and other governance documents to confirm whether the compensation committee has the requisite authority to retain, compensate and oversee advisers; and
4. working with counsel to monitor the release of the SEC's final rules and the applicable exchanges' resulting listing standards.