

April 4, 2011

SEC's Proposed Rules on Compensation Committee Independence Largely Follow Provisions of Dodd-Frank

As Expected, Key Task of Setting Independence Standards Left to Exchanges

On March 30, 2011, the Securities and Exchange Commission ("SEC") issued proposed rules¹ directing the national securities exchanges to adopt listing standards related to the independence of compensation committees and their selection of advisers. SEC rulemaking on these topics is required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Reform Act"),² which prohibits national securities exchanges from listing any equity security of an issuer not in compliance with the exchange's compensation committee independence and adviser requirements. In the proposing release, the SEC also slightly revised its proxy disclosure rules related to the use of compensation consultants by compensation committees and an issuer's management. The proposed rules largely mirror the provisions of Section 952 of the Reform Act.

The rules are not likely to affect most public companies until the exchanges promulgate their new independence standards and, even then, it is unlikely that the rules will have a significant impact on the composition of compensation committees of most companies. Once the listing standards are final, some compensation committees may need to adopt new procedures discussed below for selecting advisers, and many issuers will likely be required to revise their proxy statement disclosures related to the use of compensation consultants by committees and management. Exchanges are required to have final rules issued by no later than 90 days after publication of the SEC's final rule. The Reform Act requires the SEC's final rule to be issued no later than July 16, 2011.

The SEC's release of proposed rules constitutes the first in a series of steps that will include promulgation of final rules, development of proposed rules or rule making by the national securities exchanges, and approval by the SEC of final standards by the exchanges. Accordingly, issuers need take no immediate action in response to the SEC's proposals. The proposals nevertheless provide insight into the direction of future developments.

¹ Listing Standards for Compensation Committees, Exchange Act Release Nos. 33-9199; 34-64149 (Mar. 30, 2011).

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (July 21, 2010). If you wish to review a general discussion of the compensation-related provisions of the Reform Act, you may refer to our client publication entitled, "*Financial Reform Act Brings Significant Executive Compensation Change*" (July 15, 2010), available at <http://www.shearman.com/financial-reform-act-brings-significant-executive-compensation-change-07-15-2010/>.

Independence Requirements

For the most part, the proposed rules reiterate (with only limited technical refinement) the requirements of the Reform Act and apply to domestic issuers and foreign private issuers. Proposed Exchange Act Rule 10C directs the national securities exchanges to require that each member of an issuer's compensation committee be a member of the issuer's board of directors who is "independent" under the applicable exchange's independence standards. The rules mirror the Reform Act's mandate that each exchange develop independence requirements after considering certain factors, including the source of compensation from the issuer provided to a given director, the director's affiliation with the issuer, its subsidiaries or affiliates, as well as any other factors the exchange deems appropriate. The proposed rules do not actually establish independence standards and do not provide any safe harbors or exceptions, nor do they exempt any particular relationship between compensation committee members and issuers. These topics are left to the exchanges.

Application. The proposed rules require exchanges to apply their independence standards only to members of any committee of the board that oversees executive compensation, whether or not the committee performs other functions or is called a "compensation committee."

Exempt Issuers. The following five categories of issuers would not be subject to the compensation committee independence requirements: controlled companies, limited partnerships, companies in bankruptcy proceedings, open-end management investment companies registered under the Investment Company Act, and foreign private issuers that provide annual disclosures to shareholders of the reasons why they do not have an independent compensation committee.

Compensation Advisers

Authority to Engage Compensation Advisers, Responsibilities, and Funding. The Reform Act requires that compensation committees have the authority to retain or obtain the advice of compensation advisers. This requirement includes not only compensation consultants, but also independent legal counsel and other advisers. Compensation committees must be afforded sole discretion to appoint, compensate and oversee the work of compensation advisers. An issuer must provide its compensation committee with "appropriate funding" for payment of "reasonable compensation" to compensation advisers.

Compensation Committee Charter. Once the listing standards have been implemented, issuers should confirm that their compensation committee charter authorizes the committee to: (1) appoint compensation advisers; (2) pay fees to the compensation advisers; and (3) oversee the work of the compensation advisers. Charters should also allow for a process whereby the committee can assess the independence of its advisers in accordance with the independence factors discussed below.

Independence Factors. The Reform Act requires that a compensation committee consider certain independence factors before selecting a compensation adviser, including:

- whether the entity employing the compensation adviser provides other services to the issuer;
- the amount of fees received from the issuer by the entity employing the compensation adviser;
- the policies and procedures of the entity employing the compensation adviser designed to prevent conflicts of interest;
- any business or personal relationship between the compensation adviser and a member of the compensation committee; and
- whether the compensation adviser owns any stock in the issuer.

No Independence Requirement. The Reform Act does not require that a compensation adviser actually be independent, but only that the compensation committee must consider these factors when deciding to hire a given adviser. Accordingly, the SEC does not anticipate that exchange listing standards will impose any materiality or bright-line thresholds on the factors set forth in the Reform Act. In addition, the proposed rule does not require compensation committees to retain a compensation consultant or legal or other adviser, or preclude such adviser from providing other services to the issuer. Subject to the review process outlined above, most compensation committees should be able to continue the well-established practice of utilizing an issuer's internal or regular outside legal counsel for advice on most routine compensation matters.

Implementation

Securities Affected. The proposed rules clarify that the new listing standards apply only to issuers with listed *equity* securities.

Compared to Disclosure Proposal. The proposed disclosure rule changes to Item 407 of Regulation S-K described below would apply to all Exchange Act registrants, even those not listed on a national securities exchange.

Exemptions

The SEC would allow the exchanges to decide whether to propose that certain categories of issuers be exempted from these requirements. Exchange-proposed exemptions, however, would be subject to SEC review and approval as part of the rule finalization process.

Opportunity to Cure Defects

The proposed rule would require the exchanges to establish definitive procedures and compliance periods, if they do not already have adequate procedures in place, to be followed prior to delisting an issuer's securities. The listing requirements will create a safe harbor for any member of a compensation committee who ceases to be independent for reasons outside the member's reasonable control and allow the member to remain on the compensation committee until the earlier of the issuer's next annual meeting or one year from the event that caused the member to no longer be independent, as contemplated in the Reform Act.

Compensation Consultant Disclosure and Conflicts of Interest

The Reform Act dictates when an issuer must disclose whether the 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. Currently, Item 407 of Regulation S-K requires registrants to disclose "any role of the compensation consultants in determining or recommending the amount or form of executive and director compensation."

Given the similarities between the disclosures required under Item 407 and the Reform Act, the SEC decided to combine them into a single disclosure requirement that applies to all Exchange Act registrants subject to the proxy rules, whether listed or not, including controlled companies.³ As proposed, revised Item 407 requires a registrant to disclose during the registrant's last completed fiscal year whether its compensation committee has "retained or obtained" the advice of a compensation consultant, rather than formally "engaged" one. An instruction to the proposed rule clarifies that the phrase "obtained the advice" relates to whether a compensation committee has requested or received advice from a compensation consultant, regardless of whether there has been a formal engagement, a relationship with the compensation committee or management, or any payment of fees. This expanded disclosure trigger applies to both the description of the consultant and its work for the issuer as well as the fee disclosures required by Item 407. The proposed rules also broaden the scope of Item 407 by eliminating its exclusions for disclosure when the consultant provides advice on broad-based plans or provides only non-customized benchmark data. However, fee disclosure is still not required so long as the consultant services involved broad-based plans or non-customized benchmark data and no advice was given.

In light of the linkage between the requirement that compensation committees of listed issuers consider independence factors before retaining compensation advisers and the disclosure requirements regarding compensation consultant conflicts of interest, the proposed rules include an instruction identifying these same independence factors as a non-exclusive list of factors to be considered in determining whether there is a conflict of interest requiring disclosure. If the compensation committee determines that there is a conflict of interest, the issuer would be required to provide a clear and concise description of the specific conflict and how the issuer has addressed it; a general description of the issuer's policies and procedures on conflicts of interest would not suffice.

Looking Ahead

Once the SEC releases its final rules, and the exchanges update their listing standards and related correction procedures accordingly, companies will need to review their compensation committee and adviser practices and disclosures. Until then, no action is required.

By year-end, the SEC is expected to propose rules relating to the remaining Reform Act compensation provisions: clawbacks, pay equity, hedging policies and pay for performance. This promises to make 2011 an interesting, and perhaps watershed, year for compensation committees and the corporate governance professionals that advise them.

³ An appendix to this memorandum provides a comparison of the current version of Item 407 and the proposed changes.

Appendix

§ 229.407 (Item 407) Corporate governance.

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(iii) ~~Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation (other than any role limited to consulting on any broadbased plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) during the registrant's~~ Whether the compensation committee (or another board committee performing equivalent functions) retained or obtained the advice of a compensation consultant during the registrant's last completed fiscal year, identifying such consultants, stating whether such consultants were engaged directly by the compensation committee (or persons another board committee performing the equivalent functions) or any other person, describing the nature and scope of their the consultant's assignment, and the material elements of the instructions or directions given to the consultants consultant with respect to the performance of their the consultant's duties under the engagement, and discussing whether the work of the consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

(A) If ~~such compensation consultant was engaged by~~ the compensation committee (or ~~persons~~ another board committee performing the equivalent functions) ~~to provide~~ retained or obtained the ~~advice or recommendations on the amount or form of executive and director~~ of a compensation consultant and the consultant's services were not limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; ~~or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice;~~ ~~and the compensation consultant or its affiliates also provided additional services to the registrant or its affiliates in an amount in excess of \$120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for such additional services. Disclose whether the decision to engage the compensation consultant or its affiliates for these other services was made, or recommended, by management, and whether the compensation committee (or another board committee performing equivalent functions) or the board approved such other services of the compensation consultant or its affiliates.~~

(B) If the compensation committee (or ~~persons~~ another board committee performing the equivalent functions) has not ~~engaged~~ retained or obtained the advice of a compensation consultant, but management has ~~engaged~~ retained or obtained the advice of a compensation consultant ~~to provide advice or recommendations on the amount or form of executive and director compensation (other than any role~~ and the consultant's services were not limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; ~~or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice;~~ ~~and such compensation consultant or its affiliates has provided additional services to the registrant in an amount in excess of \$120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the compensation consultant or its affiliates.~~

Instruction 1 to Item 407(e)(3). For purposes of this paragraph, a compensation committee (or another board committee performing equivalent functions) or management has "obtained the advice" of a compensation consultant if such committee or management has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant or a client relationship between the compensation consultant and the compensation committee or management or any payment of fees to the consultant for its advice.

[Instruction 2 to Item 407\(e\)\(3\). For purposes of this paragraph, the factors outlined in §240.10C-1\(b\)\(4\)\(i\) through \(v\) of this chapter are among the factors that should be considered in determining whether a conflict of interest exists.](#)

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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