

PUBLICATION

SEC Proposes New Compensation Committee and Adviser Requirements

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On March 30, 2011, the SEC proposed rules directing the national securities exchanges to adopt listing standards regarding (a) the independence of compensation committees and (b) the authority of compensation committees to retain compensation advisers. The proposed rules also require enhanced disclosures regarding the use of compensation consultants. The proposed rules are intended to implement Section 10C of the Securities Exchange Act of 1934 (the Exchange Act), which was added by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Independence Standards

The proposed rules would require each exchange to adopt listing standards that require each member of an issuer's compensation committee to meet the definition of "independent." The exchanges are directed to adopt this definition after considering relevant factors, including, but not limited to (a) the source of a director's compensation, which includes any consulting, advisory or other compensatory fee paid by the issuer to the director and (b) whether the director is affiliated with the issuer, one of the issuer's affiliates or a subsidiary of one of the issuer's affiliates. These standards are similar to the audit committee independence rules in the Exchange Act's Section 10A, except that Section 10A requires that exchanges prohibit directors from serving as audit committee members based on such relationships. On the other hand, these proposed rules allow exchanges more flexibility in determining the independence requirements of compensation committee members, subject to the SEC's approval of the listing standards, based on factors the exchanges deem relevant, so long as the exchanges consider the above criteria.

Under the proposed rules, the following types of entities would be exempt from the requirement to have a fully independent compensation committee: controlled companies; limited partnerships; companies in bankruptcy; open-ended registered management investment companies; and foreign private issuers that annually disclose to their shareholders why they do not have an independent compensation committee.

The exchanges would be able to exempt any other category of issuer or type of relationship from these independence requirements, subject to the SEC's approval of the listing standards. However, because the NYSE and NASDAQ already require that compensation committees be comprised solely of independent directors, the proposed rules will likely have little impact on most listed issuers. The proposed rules also would not apply to independent directors of an issuer that oversee executive compensation outside of the context of a formal board committee, as currently permitted by NASDAQ. Companies should monitor the proposed listing standards, and when they review their committee membership, should also consider whether the members of their compensation committee will meet the new independence standards adopted by their exchange.

Authority to Retain Compensation Advisers

The proposed rules would require the exchanges to adopt listing standards that mandate that compensation committees have the authority, in their sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers (each a compensation adviser) with respect to compensation matters. Under the proposed rules, the compensation committee must be directly responsible for the appointment, compensation and supervision of compensation advisers, and each issuer would be

required to provide appropriate funding, as determined by the compensation committee, for the payment of reasonable compensation to compensation advisers.

While the proposed rules would not require retained compensation advisers to be independent, a compensation committee would be required to consider, at a minimum, the following independence factors before selecting a compensation adviser:

- the provision of other services to the issuer by the person that employs the compensation adviser;
- the amount of fees received from the issuer by the person that employs the compensation adviser as a percentage of the total revenue of the person that employs the adviser;
- the policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation adviser with a member of the compensation committee; and
- any stock of the issuer owned by the compensation adviser.

The exchanges would be permitted to add additional independence factors that compensation committees must consider prior to retaining compensation advisers; however, the exchanges are not authorized to develop any materiality or bright-line thresholds or cut-offs.

Enhanced Disclosure Requirements Regarding Compensation Consultants

Section 10C(c)(2) of the Exchange Act requires each issuer of listed securities to disclose in its proxy statement whether (a) its compensation committee has retained or obtained the advice of a compensation consultant and (b) the work of a compensation consultant has raised a conflict of interest, and, if so, a description of the nature of the conflict and how it is being addressed must be included. The proposed rules would extend these disclosure requirements to all issuers subject to the proxy rules, not just issuers of listed securities, by revising the existing disclosure requirements set forth in Item 407 of Regulation S-K to require that such issuers include the new disclosures in any proxy or information statement for an annual meeting at which directors are to be elected.

Under the proposed rules, a compensation committee will have obtained the advice of a compensation consultant if it has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant or payment of fees to the consultant for its advice. The new disclosure requirements broaden the existing requirements of Item 407 of Regulation S-K by requiring issuers to disclose the role of a compensation consultant limited only to consulting on a broad-based plan or providing benchmarking data that is not customized for the issuer or is customized based on parameters not developed by the compensation consultant, and about which the compensation consultant does not provide advice. Such roles are not required to be disclosed under the current version of Item 407. Importantly, these disclosure requirements only apply with respect to compensation consultants, not independent legal counsel or other advisers to a compensation committee. When considering the use of a compensation consultant, companies should be aware of the enhanced disclosures that will be required if they retain or obtain the advice of the consultant. Companies that have included Item 407 disclosures before and use a compensation consultant again will need to revise future disclosures to address the conflicts of interest provisions.

Comments on the proposed rules are due by April 29, 2011. Under the proposed rules, each exchange would be required to provide the SEC with proposed or amended listing standards meeting the rule requirements within 90 days after publication of the final rules and would be required to finalize such standards within one year of publication of the final rules. Therefore, it is uncertain as to whether the new rules would apply for the 2012 proxy season. The proposed rules may be found by clicking [here](#).

If you have questions about these proposed rules or have any other questions related to the SEC, please contact your Baker Donelson attorney.