

Alerts and Updates

SEC Proposals For Compensation Committees And Compensation Advisers

April 25, 2011

The SEC proposes that exchanges require listed issuers to have fully independent compensation committees with authority to engage, pay and oversee their own compensation advisers.

The U.S. Securities and Exchange Commission (SEC) recently proposed rules¹:

- Directing national securities exchanges to adopt new listing standards that will require listed issuers to:
 - have fully independent compensation committees under standards to be developed; and
 - authorize the compensation committee to retain its own compensation advisers and to appoint, compensate and direct the efforts of these advisers.
- That would expand current disclosure requirements regarding compensation committee advisers and related conflicts of interest.

The rules will not be finalized until after the 2011 proxy season.

New Independence Requirements for Compensation Committee Members

The SEC proposes to mandate that each of the national securities exchanges require each member of the compensation committee of a listed issuer, or any committee that performs similar functions, to be a member of the board of directors and also be "independent." In developing the definition of "independent," the national securities exchanges would have to take into consideration specified factors, such as the

director's sources of compensation – including all consulting, advisory or other compensatory fees paid by the issuer – and whether the director is affiliated with the issuer. By directing the national securities exchanges to take into account such factors, the SEC has indicated its intention that the independence standards applicable to members of compensation committees should be enhanced, perhaps in a similar manner to the standards currently applicable to audit committees.

If the rules are adopted, there will be greater scrutiny of a compensation committee member's compensation and fees from company sources. It remains to be seen whether new listing standards would specify any relationships that disqualify a director from serving on a compensation committee.

Exemptions

The requirement to have an independent compensation committee need not apply to controlled companies, limited partnerships or foreign private issuers that disclose in their annual reports the reasons why they do not have an independent compensation committee, among other issuers. Only controlled companies would be exempted from the other requirements related to the new compensation committee responsibilities and compensation advisers. In addition, the proposed requirements would not apply to issuers without a board committee that oversees executive compensation, and such issuers would not be required to adopt a compensation committee structure if one does not already exist.²

Compensation Committee Appointment and Oversight of Compensation Advisers

Under the proposed rules, each exchange would have to adopt a listing standard requiring an issuer to permit its compensation committee – in the committee's sole discretion – to retain or obtain the advice of a compensation adviser, independent legal counsel³ or other committee adviser (the "compensation advisers"). While a compensation committee would not be prohibited from engaging any compensation adviser, the SEC rules would require compensation committees *to consider* certain independence factors established by the exchange prior to engaging the adviser,

including various aspects of the relationship between the adviser's employer/firm and the issuer.⁴

Exchanges would also be required to adopt listing standards that provide that the compensation committee is responsible for the appointment, payment and oversight of compensation advisers retained by the compensation committee. Issuers would also be required to provide "appropriate funding" to cover "reasonable compensation" of the compensation advisers. The determination of what constitutes "appropriate funding" would be determined by the compensation committee – and not the full board.

New Proxy / Consent Solicitation Disclosure

Under the proposed rules, all issuers subject to the SEC's proxy rules – whether listed on an exchange or not – would be required to disclose whether their compensation committees retained or obtained the advice of a compensation adviser⁵ and whether the adviser's work raised any conflict of interest (based on specified factors). If conflicts of interest exist, issuers would be required to disclose the nature of such conflicts and how they were addressed. The other existing disclosure requirements that relate to compensation advisers in Regulation S-K would remain in a modified form.⁶ The current Regulation S-K disclosure exemption for identifying compensation advisers that give advice on broad-based plans that do not discriminate in favor of executive officers or directors and that provide noncustomized information would be entirely eliminated from Regulation S-K.⁷

Comments and Timing

Comments on the SEC's proposed rules are due by April 29, 2011. Under the Dodd-Frank Act, the SEC must issue final rules by July 16, 2011. The SEC has proposed that once these final rules are published, the national securities exchanges will have 90 days to submit their proposed listing standards to the SEC and one year to issue final listing standards. Given this timeline, the new listing standards may not be in place in time for the 2012 proxy season.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes the firm's comprehensive series of *Alerts* analyzing the provisions of the Dodd-Frank Act and emerging policies, as well as videos and links to relevant government websites. Duane Morris' attorneys are monitoring the rules and regulations released under the Dodd-Frank Act, as well as the regulatory agencies' interpretive guidance, and continuously update the **Financial Services Reform Center**.

For Further Information

If you have any questions regarding the proposed changes discussed in this *Alert*, including how they may affect your company, please contact one of the [members](#) of the **Securities Law Practice Group** or the lawyer in the firm with whom you are regularly in contact.

Notes

1. See SEC Release No. 33-9199, available at www.sec.gov/rules/proposed/2011/33-9199.pdf. The rules, which implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, H.R. 4173 (July 21, 2010) (the "Dodd-Frank Act"), would add a new Section 10C-1 to the Securities Exchange Act of 1934 (the "Exchange Act"); amend Section 407(e)(3) of Regulation S-K; and require the adoption of new listing standards by national securities exchanges and national securities associations (collectively referred to in this *Alert* as "national securities exchanges" or "exchanges"). The proposed rules do not significantly expand upon the provisions of Section 952 of the Dodd-Frank Act.
2. However, the national securities exchanges may require a listed company to have a compensation committee, as the New York Stock Exchange currently does under Section 303A.05 of its Listed Company Manual.

3. Similar to the SEC's interpretation in the context of audit committees, the compensation committee is not required to hire legal counsel, nor must any legal counsel hired be "independent."
4. See Exchange Act, Section 10C(b)(2) and proposal for Exchange Act, Section 10C-1(b)(4). Exchange Act, Section 10C(b) requires that the independence factors be competitively neutral and include, at a minimum:
 - other services provided by the employer/firm to the issuer;
 - fees received by the employer/firm as a percentage of its total revenue;
 - policies and procedures of the employer/firm designed to prevent conflicts;
 - the relationship of the compensation adviser to the members of the compensation committee; and
 - issuer stock owned by the compensation adviser.

The national securities exchanges may also expand the factors above or add additional independence factors.

5. This standard is changed from whether the *compensation adviser* had a role in "determining or recommending the amount or form of executive and director compensation." Regulation S-K, Section 407(e)(3)(iii).
6. See Regulation S-K, Section 407(e)(3)(iii).
7. See Regulation S-K, Section 407(e)(3)(iii) (first parenthetical).

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