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Compensation Committees: SEC Has Exchanges Map Director Independence (Like Audit Committees?); Orders New Review for Advisors' Independence, Disclosure of Conflicts

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On June 20, 2012, the Securities and Exchange Commission adopted new Rule 10C-1 under the Securities Exchange Act of 1934. National securities exchanges are now required (1) to consider new independence requirements for members of compensation committees of most listed companies, and (2) to mandate that such committees be empowered to retain advisers with funding from the issuer, after consideration of the independence of the adviser. The Commission's rulemaking also imposes a new requirement to make proxy statement disclosure of the nature of any conflict of interest raised by the use of compensation consultants.

Operative Dates

The national securities exchanges must propose their new rules for SEC approval by September 25, 2012. Exchange rules must be approved by the SEC and in place no later than June 27, 2013. The new disclosure requirements will first apply to a proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013.

Compensation Committee Independence

How did we get here?

Currently, prior to any new exchange rulemaking, the members of the compensation committees of listed issuers are already required to be "independent." The NYSE adopted rules in 2003 requiring each listed company to have a compensation committee made up entirely of independent directors. NASDAQ adopted standards in 2003 requiring that the compensation of the CEO and officers of listed companies be determined or recommended to the board for determination by either a majority of the independent directors or a compensation committee made up entirely of independent directors.

The existing NYSE and NASDAQ requirements that compensation committee members be independent, utilize definitions of independence that apply to directors generally.[1] Under NYSE rules, in order to be considered independent, the board of directors must make a determination that the director has no material relationship with the company. Certain relationships preclude a

determination of independence. Among other things, a director is not considered independent if, during the previous three years, the director received, or has an immediate family member who received, more than $120,000 in direct compensation from the listed company in any year, other than director and committee fees and other specified types of payments. Also, a director is not independent if he is currently employed or has a family member who is currently employed by another company that during the past three years has made payments to or received payments from the listed company in an amount that exceeds, in any fiscal year, the greater of $1 million or 2 percent of the other company's consolidated gross revenues. NASDAQ has comparable requirements with, in some cases, different numerical thresholds.

Against this backdrop, notwithstanding these existing independence requirements, section 952 of the Dodd-Frank Act, enacted July 21, 2010 amid increasing public scrutiny of executive compensation, required the SEC to direct the national securities exchanges to adopt listing standards requiring that compensation committees be "independent." The statute instructed the SEC to direct the national securities exchanges, in determining the definition of independence for compensation committee members, to "consider relevant factors, including (A) the source of compensation of [the member], including any consulting, advisory, or other compensatory fee paid by the issuer to [the member]; and (B) whether [the member] is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer."

The SEC has now by rule directed the national securities exchanges to act in accordance with the statutory mandate.[2] In making this direction, the SEC declined to specify any additional factors that the exchanges should consider, beyond the two mentioned in the statute. Also, the rule does not elaborate on the meaning of the specified factors, but simply repeats the statutory language.

What next?

It is now incumbent on each national securities exchange (principally the NYSE, NYSE Amex and The NASDAQ Stock Exchange) to make a submission to the SEC within the time period specified. The submission must include a review of whether and how the exchange's existing or proposed listing standards comply with the rule's requirement that compensation committee members be "independent," including a discussion of the consideration of factors relevant to compensation committee independence conducted by the exchange, and the definition of independence that the exchange proposes to adopt or retain in light of such consideration.

Rule 10C-1 does not require the national securities exchanges to modify current independence requirements for compensation committee members. It is only required that the exchanges "consider" relevant factors, including the two enumerated. It would be possible for the exchanges to file submissions stating that they had considered relevant factors, including the two enumerated, and concluded that the existing independence standards should not be changed.

However, the enactment of section 952 of the Dodd-Frank Act against the backdrop of existing requirements may be thought to express a strong legislative desire for the national securities exchanges to propose some change in their definition of "independence," as applied to compensation committee members. The SEC will review the exchanges' submissions and determine whether the exchanges' proposed rule changes (or, theoretically, a proposal that no change be made) are consistent with the requirements of section 6(b) of the 1934 Act, including the protection of investors and the public interest. The SEC could reject submissions that in its view do not meet such requirement, and the exchanges may well have this, and the statutory context, in mind as they determine whether and how to modify their existing definitions of independence with regard to compensation committee members.

The audit committee experience.

A short review of the development of independence requirements for audit committees may be instructive in gauging the possible content of upcoming exchange action for compensation committees.

Audit committee members of listed companies must be "independent," utilizing the national securities exchanges' definition of independence applicable to all directors, discussed above. However, audit committee members also are subject to special independence requirements imposed by SEC Rule 10A-3 adopted April 2003, and NYSE and NASDAQ implementing rules adopted in November 2003.

Rule 10A-3 was adopted by the SEC pursuant to section 301 of the Sarbanes-Oxley Act, enacted in 2002. This section used an approach to audit committee regulation similar to, but with one important difference from, the approach to compensation committee regulation used in section 952 of the Dodd-Frank Act. In the Sarbanes-Oxley Act, the SEC was required to direct national securities exchanges to adopt listing requirements mandating that each member of a listed company's audit committee be independent. The statute required use of an independence definition commanding that the member may not, other than in his capacity as a board member, "(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof."

These two elements of the definition of audit committee independence are strikingly similar to the factors specified in section 952 of Dodd-Frank for compensation committees.[3] However, in the case of compensation committees, the factors need only be "considered" by the national securities exchanges; for audit committees, the factors are prescriptive requirements.

In implementing section 301 of Sarbanes-Oxley, the SEC amplified the no-compensation requirement specified in the statute into a more detailed definition (Rule 10A-3(b)(1)(ii)(A)). As expressed in the rule, audit committee members are prohibited from accepting "directly or indirectly, any" compensatory fee (there is no minimum amount) from the issuer or any subsidiary (other than specified retirement compensation). Rule 10A-3(e)(8) further details this requirement by defining "indirect acceptance" by a member of an audit committee of a

compensatory fee to include acceptance of such a fee by a spouse or minor children or children sharing the same home, or by an entity in which the member is a "partner, member, an officer such as a managing director occupying a similar position" who provides "accounting, consulting, legal, investment banking, or financial advisory services" to the issuer or any subsidiary of the issuer.

This requirement operates so as to generally preclude partners of law firms, consulting firms, investment banking or financial advisory firms, who provide services to the issuer from serving on the listed issuer's audit committee. For audit committees, the SEC also amplified the non-affiliate requirement specified in Sarbanes-Oxley. Rule 10A-3(b)(1)(ii)(B) requires that a member of the audit committee not be (other than in his capacity as a director) an "affiliated person" of the issuer or any subsidiary. Rule 10A-3(e) defines affiliate as a person who directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with the person specified, here, the issuer or any subsidiary. However, a person will be deemed not to be in control of the issuer or subsidiary for these purposes if the person is not the beneficial owner of more than 10 percent of any class of voting equity securities of the issuer or subsidiary, and is not an executive officer of such entity. Under the rule, certain persons having certain relationships with affiliates of the issuer or subsidiary will also be deemed to be affiliates of the issuer or subsidiary: executive officers of the affiliate; a director who is also an employee of the affiliate; a general partner of the affiliate; and a managing member of the affiliate. The rule contains a special provision relating to dual holding companies.

Such compensation and non-affiliate requirements are not currently operative for compensation committees, and Rule 10C-1 does not require them to be. However, given that the factors now required to be "considered" by the national securities exchanges for compensation committees are counterparts of the elements required for audit committees, it is quite possible that the exchanges could in the coming months propose to make the same or similar compensation and non-affiliate independence requirements applicable to compensation committee members as have been imposed upon audit committee members since 2003.

On the other hand, it is open to the national securities exchanges to conclude that in certain respects, different independence considerations are relevant in the context of the operation of a compensation committee than are relevant to an audit committee. In particular, exchanges may take note of the SEC's statement in the release adopting Rule 10C-1 that in establishing their independence requirements, the exchanges may determine that, even though affiliated directors are not allowed to serve on audit committees, such a blanket prohibition would be inappropriate for compensation committees, and certain affiliates, such as representatives of significant shareholders, should be permitted to serve.[4] In addition, the SEC emphasized that it is important to consider other ties between a listed issuer and a director that might impair the director's judgment as a member of the compensation committee, such as personal or business relationships between members of the compensation committee and the listed issuer's executive officers.

Compensation Advisers

Under Rule 10C-1(b)(2), the listing standards to be adopted by the national securities exchanges must specify that the compensation committee of a listed issuer must have the power in its sole discretion to retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser; that the compensation committee is directly responsible for the appointment, compensation and oversight of the work of any such consultant, counsel or other adviser; and that the issuer must provide appropriate funding, as determined by the compensation committee, for payment or reasonable compensation to such consultant, counsel or adviser. However, the compensation committee is not to be required, under such listing standards, to implement or act consistently with the advice or recommendations of the compensation consultant, independent legal counsel or other adviser to the compensation committee.

In the adopting release, the SEC noted that the requirement that a compensation committee be empowered to engage "independent" legal counsel does not require that counsel engaged by the committee be independent, and does not preclude 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.[5]

Under the Rule as adopted, the listing standards adopted by the national securities exchanges must require that a compensation committee, prior to receiving advice from any compensation consultant, legal counsel or other adviser, conduct an independence assessment of such consultant, counsel or other adviser. The committee is not required to determine that any such consultant, counsel or other adviser is independent, and is permitted to retain such persons who are not independent. However, an independence assessment is required in every case, the only exception being when the committee receives advice from in-house counsel.

The listing standards must provide that in the independence assessment, the committee must consider such factors as the exchange identifies, but must include six enumerated factors: (1) the provision of other services to the issuer by the person who employers the adviser; (2) the amount of fees received from the issuer by the person who employers the adviser, as a percentage of the total revenue of the person who employs the adviser; (3) the policies and procedures of the person who employs the adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the adviser with a member of the committee; (5) any stock of the issuer owned by the adviser; and (6) any business or personal relationship of the adviser with an executive officer of the issuer.

Since these enumerated factors are required to be included in the listing standards, companies may wish now to inform advisers, such as compensation consultants and legal counsel (including counsel retained by the issuer) who in the past have provided advice to the compensation committee, that they should be prepared to submit information to the committee that is responsive to these factors.

Disclosure Requirements

Currently, prior to the SEC rulemaking, Item 407(e)(3)(iii) of Regulation S-K requires proxy statement disclosure of any role of compensation consultants[6] in determining or recommending the amount or form of executive and director compensation (other than any role 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).

In the SEC's rulemaking, the disclosure requirements specified in section 952 of Dodd-Frank were incorporated into existing S-K Item 407(e)(3) through the addition of new paragraph Item 407(e)(3)(iv). Under new Item 407(e)(3)(iv), with regard to any compensation consultant described in Item 407(e)(3)(iii), whose work has raised any conflict of interest, disclosure will be required of the nature of the conflict and how the conflict is being addressed.

The new disclosures are limited to compensation consultants described in Item 407(e)(3)(iii), which refers to consultants who have played "any role" in determining or recommending the form of executive and director compensation. "Any role" would apply regardless of whether the compensation consultant was retained by management or the compensation committee, or any other board committee. However, no disclosure is required for consultants for specified broad-based plans or who provide only general information of specified types.

An instruction to new paragraph Item 407(e)(3)(iv) makes the point that the same six factors specified in Rule 10C-1 to be considered in a compensation committee's required independence assessment of a compensation consultant (see above) should be considered in determining whether a conflict of interest exists, triggering the new disclosure requirements.

The new disclosure requirements will first apply to a proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013.

If you have questions regarding the new SEC rulemaking, please contact any of the lawyers listed, or your regular Reed Smith contact.

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[1] These independence definitions also operate, for example, in conjunction with the NYSE and NASDAQ requirements that listed issuers have a majority of directors who are independent.

[2] Excluded from the independence requirements are: limited partnerships; companies in bankruptcy proceedings; open-end management investment companies registered under the Investment Company Act of 1940; and any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee.

[3] In the release adopting new Rule 10C-1, the SEC noted that section 952 of Dodd-Frank essentially provides the compensation committee counterpart to the audit committee requirements of section 301 of Sarbanes-Oxley. Release 33-9330, p 17.

[4] Release 33-9330, p.24.

[5] *Id.* p.27.

[6] "Compensation consultants" here does not include legal counsel.