SEC Proposes New Rules on Compensation Committee Independence and Adviser Conflicts

On March 30, 2011, the Securities and Exchange Commission proposed rules to implement provisions of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* relating to compensation committee membership and adviser conflicts. The proposals direct national securities exchanges to adopt listing standards in three areas: compensation committee independence, the use of compensation consultants and compensation consultant conflicts of interest. The proposed rules largely mirror the requirements of corresponding provisions of the Dodd-Frank Act and reflect an ever-increasing focus on the process for determining executive compensation at public companies.

A brief description of the proposals follows. The proposing release and the text of the rules may be found at the SEC's website here. The SEC is accepting comments until April 29, 2011.

Exchange Listing Standards

The proposed rules are not self-operative and, if adopted, require national securities exchanges to adopt new listing standards. Any issuer not in compliance with the new listing standards, once effective, would be given a reasonable opportunity to cure any defects before any delisting of its securities.

A. Compensation Committee Independence

The proposed rules call for listing standards that would require each member of a listed issuer's compensation committee to be a member of its board of directors and to be "independent," as defined by the applicable exchange. In defining independence, the SEC directs the exchanges to consider (1) the source of compensation of a director, including any consulting, advisory, or other compensatory fee paid by the issuer to such director, and (2) whether a director is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer. Subject to SEC approval, exchanges would have discretion in defining "independence." For example, the SEC notes that exchanges would have discretion to determine the appropriateness of allowing directors affiliated with significant investors, such as private equity or venture capital sponsors, to serve on compensation committees. Exchanges might also consider how any relationship(s) between a compensation committee member and management should bear on a determination of independence.

The new listing standards would apply to any committee that oversees executive compensation, whether or not formally designated as a "compensation committee," but would not require that an issuer establish a compensation committee. The SEC explains in the proposing release that the new independence standard is not intended to apply to issuers whose independent directors oversee executive compensation in lieu of a committee, but the SEC requests comment on whether the final rules should, in fact, apply to such directors acting in the absence of a formal committee structure.

B. Engagement of Compensation Advisers

Consistent with a general trend of encouraging the retention of independent consultants, under the proposed rules each listed issuer would be required to comply with the following requirements:

- each compensation committee must have the authority, in its sole discretion, to retain compensation consultants, independent legal counsel and other advisers;
- the compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser; and
- each listed issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to compensate advisers.

Though a compensation committee would have the authority to hire "independent legal counsel" as a compensation adviser or in other capacities, a committee would not be required to do so. Thus, compensation committees could rely on in-house counsel or outside counsel retained by the issuer or management in addition to or instead of independent legal counsel.

C. Compensation Adviser Independence Factors

The proposed rules would not require compensation advisers to be independent. However, before selecting any compensation adviser, the compensation committee of an issuer would be required to take into consideration factors to be identified by the relevant exchange, including:

- the provision of other services to the issuer by the compensation consultant, legal counsel or other adviser;
- the amount of fees received from the issuer by the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the compensation consultant, legal counsel or other adviser;
- the policies and procedures of the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; and
- any stock of the issuer owned by the individuals (or immediate family members) providing compensation services to the issuer on behalf of a compensation consultant, legal counsel or other adviser.

Because the new rule would not prohibit retention of an adviser that has been determined not to be independent, the SEC did not include any materiality thresholds with respect to the factors listed above.

D. Exemptions

Controlled companies, limited partnerships, companies in bankruptcy proceedings, open-end management investment companies registered under the Investment Company Act of 1940 and certain foreign private issuers will not be subject to the new standards. Each exchange may also determine whether other categories of issuers – for instance, smaller reporting companies – should be exempt. This determination, however, would be subject to SEC review. The SEC is soliciting comment about the appropriateness of exempting from the proposed rules smaller reporting companies and other categories of issuers.

Similarly, exchanges also would be permitted to exempt particular relationships between members of the compensation committee and listed issuers, taking into consideration the size of an issuer and any other relevant factors.

Disclosure Rules on Compensation Consultants and Conflicts of Interest

Furthering a general initiative to increase disclosure and transparency, each issuer (whether or not listed) would be required, under the proposed rules, to disclose in any proxy or information statement for a shareholder meeting at which directors are to be elected:

- whether the issuer's compensation committee retained or obtained the advice of a compensation consultant during the last completed fiscal year;[1]
- whether the work of the compensation consultant has raised any conflict of interest; and
- the nature of the conflict, if any, and how it is being addressed.

The SEC proposes to define "obtained the advice" broadly as existing where a compensation committee or management has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement, client relationship or payment of fees to the consultant for advice.

These new disclosure requirements would be implemented by integrating the proposals with the existing requirements of Item 407 of Regulation S-K relating to compensation consultants.

To provide guidance to issuers as to the factors to be considered in determining whether there is a "conflict of interest," the SEC proposes using the same five factors to be considered in determining the independence of compensation advisers. If a compensation committee were to determine, after considering these factors, that a conflict of interest was present, the issuer would be required to provide a clear, concise and understandable description of the specific conflict and how the issuer has addressed it.

These new disclosure requirements would apply to all issuers subject to Exchange Act proxy rules, whether listed or not, and whether a controlled company or not. Notwithstanding that the Dodd-Frank Act requires such disclosure to be included in proxy or information statements relating to shareholder meetings held on

[1] This disclosure would be required, however, without regard to the existing exceptions in Item 407, including advice on broad-based plans and the provision of non-customized benchmark data.

or after July 21, 2011, the proposing release indicates that the disclosure would not be required for proxy or information statements filed in definitive form before the effective date to be set forth in the final rules.

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If you would like to discuss these or any other governance or securities law matters, please contact any member of Ropes & Gray's Securities & Public Companies practice or Executive Compensation practice or your usual Ropes & Gray advisor.