

March 31, 2011

## **SEC PROPOSES RULES ON COMPENSATION COMMITTEE INDEPENDENCE AND THE ROLE OF COMPENSATION CONSULTANTS AND OTHER ADVISERS**

To Our Clients and Friends:

On March 30, 2011, the Securities and Exchange Commission (the "SEC") voted unanimously to propose rules implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") relating to: (1) compensation committee member independence; (2) compensation consultant and other adviser independence; and (3) compensation committee authority to retain, and disclosure regarding use of, compensation consultants and other advisers. In our July 21, 2010 client memorandum, available [here](#), we describe in detail Section 952 of the Dodd-Frank Act, which added a new Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act").

The proposing release is available [here](#). The SEC is seeking public comments on these proposed rules through April 29, 2011.

### **I. Compensation Committee Member Independence**

Similar to the heightened independence requirements imposed on audit committees and their advisers under the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), Section 10C of the Exchange Act mandates that stock exchanges adopt listing standards requiring listed companies to have independent compensation committee members. As described below, however, Section 10C and the proposed rule contain important differences from the audit committee requirements in the Sarbanes-Oxley Act. For example, Section 10C and the proposed rule leave greater discretion to the exchanges in developing a definition of independence.

Consistent with Section 10C, the proposed rule would require that each member of a board's compensation committee be independent under a definition of independence to be established by the exchanges. In adopting this definition, the exchanges must consider relevant factors, including, but not limited to, the sources of compensation paid to any compensation committee member (including any consulting, advisory or other compensatory fees paid) and whether the member is affiliated with the issuer.

As required by the statute, the SEC's proposed rule would direct the exchanges to prohibit the listing of any equity security of a company not in compliance with the compensation committee independence requirement set forth in Section 10C. Companies will be provided with a reasonable opportunity to cure any defects prior to being delisted. The proposed rule states that an exchange may permit a compensation committee member who ceases to be independent for reasons outside the member's reasonable control to remain a compensation committee member until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member to be no longer independent.

The SEC's proposed rule provides that the new independence requirement would apply to a listed company's compensation committee or, if the company does not have a compensation committee, to a committee that performs the functions typically performed by a compensation committee. Although the proposed rule would not apply to a listed company that does not have either a compensation committee or another committee that oversees compensation, this is not likely to be significant as a practical matter, as most listed companies have a compensation committee or other committee that oversees compensation. Although Nasdaq permits a group of independent directors that is not a committee to oversee compensation, NYSE specifically requires that its listed companies have a compensation committee.

***Comparison to Rule 10A-3.*** The proposed rule for compensation committees provides that each member of a listed company's compensation committee must be independent, just as the Rule 10A-3 standards applicable to audit committees require that each listed company audit committee member must be independent. The SEC's proposed rule on compensation committee listing standards, however, contains significant differences from Rule 10A-3.

As compared to Rule 10A-3, the proposed rule for compensation committees leaves greater discretion to the exchanges in developing a definition of independence. Following the language of Section 10C, the proposed rule states that the exchanges "shall consider" relevant factors, including, but not limited to, the sources of compensation paid to any compensation committee member and whether the member is affiliated with the issuer or an affiliate or subsidiary thereof. By contrast, Rule 10A-3 provides that an audit committee member "may not" accept compensatory fees from the issuer or be an affiliate of the issuer or a subsidiary. In addition, Rule 10A-3 contains a separate definition of affiliate for the purposes of the audit committee independence requirement, while the proposed rule does not define affiliate and indicates that affiliated status is one factor for the exchanges to consider.

***Practical Considerations.*** The specific independence definitions adopted by the exchanges will be particularly important for directors who are affiliates of significant shareholders, such as private equity funds or venture capital firms. Directors representing such investors often have sought to be members of compensation committees. Depending on how the exchanges draft the definition of independence, such directors may be prohibited from serving on compensation committees if they are considered affiliates of the issuer. The proposing release states, however, that 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."

## **II. Compensation Consultants and Other Advisers**

As required by Section 10C of the Exchange Act, the SEC's proposed rules also contain provisions relating to compensation consultant and other adviser independence and the authority of compensation committees to retain, and disclosure regarding use of, compensation consultants and other advisers.

***Compensation Consultant and Other Adviser Independence.*** Section 10C requires that any compensation consultant and other adviser, including legal counsel, to the compensation committee of a listed company may be selected only after the compensation committee has taken into account

independence factors to be established by the SEC, which factors must be competitively neutral and preserve the ability of compensation committees to retain any category of adviser. These factors must include: (1) provision of other services by the employer of the compensation consultant or adviser; (2) the amount of fees received by the employer of the compensation consultant or adviser as a percentage of its total revenue; (3) policies of the employer of the compensation consultant or adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship between the compensation consultant or adviser and a member of the compensation committee; and (5) any stock of the issuer owned by the compensation consultant or adviser. These factors illustrate that Section 10C distinguishes between the individual providing advice to the compensation committee and the firm that employs that individual. As with the compensation committee member independence requirement discussed above, the independence rule relating to compensation consultants and other advisers is to be implemented through exchange listing standards.

The proposed rule states that compensation committees must consider the five independence factors identified in the statute and any additional independence factors identified in applicable listing standards. The SEC did not address any factors in the proposed rule beyond those identified in Section 10C.

***Authority to Retain Compensation Consultants and Other Advisers.*** The SEC's proposing release also contains a rule required by Section 10C regarding the authority of a compensation committee to retain compensation consultants and other advisers. The proposed rule provides that a listed company's compensation committee in its sole discretion may retain or obtain the advice of a compensation consultant or other adviser, including independent legal counsel. It further provides that the compensation committee shall be directly responsible for the appointment, compensation and oversight of a compensation consultant or other adviser to the committee, although the committee is not required to follow the recommendations of such consultant or other adviser and must continue to exercise its own judgment in fulfilling its duties. Issuers are required to provide appropriate funding for compensation consultants, independent legal counsel and other advisers to the compensation committee. This proposed rule also is to be implemented through exchange listing standards.

The SEC's proposed rule would not prohibit a compensation committee from retaining legal counsel or other advisers who are not independent, even though Section 10C grants compensation committees express authority to retain "independent legal counsel." The SEC's proposing release states that "we do not construe the requirements related to independent legal counsel and other advisers as set forth in [Section 10C] as requiring a compensation committee to retain independent legal counsel or as precluding 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." Despite this statement that the proposed rule would not prohibit a compensation committee from obtaining the advice of in-house counsel or company counsel, the proposed rule does not address whether the compensation committee would need to assess the independence of such advisers before obtaining advice from them.

***Disclosure Regarding Use of Compensation Consultants.*** Section 10C requires that, in each proxy statement filed by an issuer for an annual meeting, a company must disclose whether its compensation

committee has retained or obtained the advice of a compensation consultant, whether the consultant's work raised any conflicts of interest and how any such conflicts are being addressed.

The SEC's proposed rule would implement this disclosure requirement through a revision to Item 407(e)(3)(iii) of Regulation S-K. Item 407(e)(3)(iii) currently contains detailed disclosure requirements relating to "any role of compensation consultants in determining or recommending the amount or form of executive or director compensation." The proposed revision generally would leave the current disclosure requirements unaffected, except:

- To provide that the trigger for disclosure under Item 407(e)(3)(iii) is the retention of or obtaining advice from a compensation consultant, rather than a compensation consultant playing "any role" in determining or recommending compensation;
- To remove the existing exceptions to the disclosure requirement for compensation consultants who consult only on broad-based plans that are generally available to all salaried employees or who provide information not customized to the particular company; and
- To add the requirement that a company disclose whether the compensation consultant's work raised any conflicts of interest and, if so, how such conflicts are being addressed.

The proposed rule also would add an instruction to Item 407(e)(3) stating that, in determining whether a conflict of interest exists, a company should consider the five independence factors listed above under "Compensation Consultant and Other Adviser Independence."

### **III. Applicability and Exemptions**

Consistent with Section 10C, the proposed rules that are to be implemented through exchange listing standards (i.e., those relating to compensation committee member independence, compensation consultant and other adviser independence and compensation committee authority to retain compensation consultants and other advisers) generally would apply to all listed companies. The proposed rules, however, contain exemptions from the listing standards:

- The following would be exempt from all listing standards:
  - Controlled companies;
  - Issuers of securities futures products cleared by a registered clearing agency or a clearing agency exempt from registration; and
  - Registered clearing agencies that issue standardized options.

- In addition to the previous exemptions, the following exemptions would apply to the listing standards relating to compensation committee member independence:
  - 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 issuer does not have an independent compensation committee.

The proposed rules provide that the exchanges would be permitted to propose other exemptions to the listing standards, and in doing so are required to take into account the potential impact of the requirements of Section 10C on smaller reporting issuers.

The proposed rules also provide that the new disclosure requirements described above under "Disclosure Regarding Use of Compensation Consultants" would apply to all companies subject to the SEC's proxy rules, including companies that are not listed and controlled companies.

#### **IV. Transition and Timing**

The proposed rules provide that, no later than 90 days after publication of the SEC's final rules, each exchange must provide to the SEC proposed rules or rule amendments. Further, each exchange will need to have final rules or rule amendments approved by the SEC no later than one year after publication of the SEC's final rules.

Regarding the proposed revision to Item 407(e)(3)(iii), Section 10C(c)(2) requires the new disclosures to be included in any proxy or consent solicitation material for an annual meeting of shareholders occurring on or after the date that is one year after the enactment of Section 10C, which is July 21, 2011. As the proposing release notes, however, the statute also requires these disclosures to be "in accordance with regulations of the Commission," and the SEC's regulations do not currently require such disclosures. Consequently, the new disclosures will not be required for proxy or information statements filed in definitive form before the effective date of the rules implementing Section 10C(c)(2).



*Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you work, or any of the following:*

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