Cooley

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The SEC has just proposed new rules that would require the national securities exchanges to adopt new listing standards designed to promote the independence of compensation committee members, consultants and advisers. The proposed new rule and rule amendments implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, codified in Section 10C of the Securities Exchange Act of 1934, and closely track its provisions without significant expansion. Because the proposal is, for the most part, no more prescriptive than Section 10C itself, it provides the exchanges with substantial discretion and also leaves to the exchanges any heavy lifting that might be required in formulating definitions or other requirements. No new or modified proxy statement disclosure will be required as result of the new proposal during the current proxy season.

Independent compensation committee members

Under the proposal, the national securities exchanges would be required to establish listing standards that require each member of a listed issuer's compensation committee to be a director and to be "independent." The term "independent" is not defined. Instead, the term is to be defined by the exchanges after taking into consideration "relevant factors" prescribed by Section 10C, including the following:

- the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to that member of the board of directors, and
- whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The SEC does not propose to specify any additional factors that should or must be considered.

Nothing in Section 10C, as interpreted by the SEC, requires a listed issuer to have a compensation committee or even a committee that performs functions typically assigned to a compensation committee. As a result, conforming to the limited mandate of Section 10C as interpreted by the SEC, the proposal does not obligate listed issuers to establish compensation committees. Notably, while the listing standards of the NYSE require listed issuers to have compensation committees, the NASDAQ listing standards do not, requiring only that executive compensation be determined or recommended to the board either by an independent compensation committee or by a majority of the board's independent directors in a separate vote.

The proposed rules would require that the listing standards apply to any "committee" of the board that oversees executive compensation, even if the committee is not formally designated as a "compensation committee." However, they would not require the listing standards to apply to those independent directors who oversee executive compensation in lieu of a board committee. In the SEC's view, under state corporate law, such action by the independent directors would generally be considered action by the full board, not action by a committee, and thus presumably beyond the literal mandate of Section 10C.

Although the factors specified in Section 10C for compensation committee independence largely parallel those specified in Sarbanes-Oxley for audit committee independence, Section 10C does not require, and the proposal would not impose, the mandatory features of audit committee independence on compensation committee members, allowing the exchanges more discretion to determine those standards of independence. As a result, unlike the rules for audit committees, the proposal does not provide a safe harbor for affiliate status. The SEC suggests that there may well be good reasons for the exchanges not to impose the same bright-line prohibitions: for example, affiliates that represent significant investors may be especially rigorous in their oversight of compensation and could have interests that are closely aligned with shareholders. Likewise, the exchanges could conclude that the definition of independence should more appropriately address relationships between compensation committee members and management.

Compensation consultants, legal counsel and other

advisers

Authority to Engage. Consistent with Section 10C, the proposed rules require that compensation committees of listed companies have the following authority and responsibility:

- authority, in their sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers;
- direct responsibility for the appointment, compensation and oversight of the work of compensation advisers;
- requirement to exercise their own judgment in fulfilling their duties with no obligation to implement or act consistently with the advice or recommendations of compensation consultants, legal counsel or other advisers; and
- entitlement to appropriate funding from the listed issuer to pay for the committee's consultants, counsel and advisers.

Independence of Consultants, Legal Counsel and Other Advisers. Under the proposal, compensation committees are not required to select consultants, counsel or advisers that are "independent," but instead, in making their selections, compensation committees must take into account the following five factors, drawn directly from Section 10C, which bear upon independence:

- the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;
- the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;
- the policies and procedures of the person that employs 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 compensation consultant, legal counsel or other adviser.

Note that the SEC does not view stock ownership of the person employing the adviser (as opposed to the individual adviser) or personal or business relationships between the person employing the adviser (as opposed to the individual adviser) and members of the compensation committee to be covered by the proposed rule.

Because independence is not mandatory, the SEC has not proposed, nor does it propose that the exchanges be permitted to include in their listing standards, any materiality or bright-line numerical thresholds related to stock ownership, amount of revenues or any of the other factors. Although the SEC believes the factors identified are generally comprehensive, the exchanges have discretion to add other independence factors that must be considered by compensation committees. The SEC is soliciting comment as to whether the factors are "competitively neutral" as required by Section 10C and whether the rules should provide further clarification of terms such as "personal" or "business."

Opportunity to Cure Defects. As required by Section 10C, the proposed rules would require the exchanges to establish procedures giving issuers a reasonable opportunity to cure any defects that would be the basis for delisting for non-compliance with the new listing standards. The SEC believes that existing continued listing or maintenance standards and delisting procedures of most of the exchanges would already satisfy this requirement. As with the rules related to audit committee members, the proposed rules allow the exchanges to provide that, if a member of a compensation committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member of the listed issuer until the earlier of the next annual meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

Exemptions. Consistent with Section 10C, the proposed rules expressly exempt controlled companies (defined as companies in which more than 50% of voting power in the election of directors is held by an individual, a group or another issuer), limited partnerships, companies in bankruptcy, registered open-end management investment companies and foreign private issuers that disclose annually the reasons that they do not have independent compensation committees. The exchanges are also granted authority to exempt particular relationships and to adopt other exemptions as appropriate, such as exemptions for smaller reporting issuers.

Compensation consultant disclosure and conflicts of interest

Section 10C requires each listed issuer to disclose in its annual meeting proxy statement whether its compensation committee retained or obtained the advice of a compensation consultant, whether the work of the consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. In the only apparent deviation from Section 10C, to avoid confusion, the proposal would apply these disclosure requirements to all Exchange Act companies (including controlled companies), not just listed companies.

As Item 407(e)(3) of Regulation S-K already requires disclosure of fees and other information regarding compensation consultants, the proposal would integrate and harmonize the Section 10C requirements with those currently in Regulation S-K. For example, the current rules trigger disclosure if compensation consultants played "any role" in the company's process for determining compensation. The proposal would instead trigger disclosure based on whether the "compensation committee retained or obtained the advice of a compensation consultant."

To be consistent with Section 10C, with regard to conflict-of-interest disclosure, the proposal would remove the exemption in the current rules for consulting in connection with broad-based plans and non-customized survey data. However, that exemption would remain in connection with fee disclosure.

A new instruction would clarify that the phrase "obtained the advice" relates to whether a compensation committee or management has requested or received advice from a compensation consultant, regardless of the existence of a formal engagement or client relationship or any payment of fees.

The proposal would also expand the focus of current Item 407(e)(3) to cover a broader scope of conflicts of interest. Currently, the focus of Item 407(e)(3) is on whether any conflicts of interest may lead a consultant to provide executive compensation advice favored by management so as to obtain other, perhaps more lucrative, consulting assignments. The proposal seeks to make that inquiry more open-ended by adding an instruction to Item 407(e)(3) providing guidance that, in considering whether a conflict of interest was created, companies should take into account the five independence factors (identified above) that compensation committees must consider when retaining compensation advisers. The SEC does not intend that the presence or absence of any of these individual factors, or even disclosure of the payment of fees, would necessarily indicate the presence of a conflict of interest. Likewise, in this facts-and-circumstances determination, other circumstances or factors might well be indicative of a conflict of interest. If the committee determined that a conflict of interest did exist, the company would be required to describe the conflict clearly, concisely and understandably. In addition, the company would need to describe how the conflict was addressed: a general description of the company's policies and procedures to address conflicts would not suffice.

The SEC is requesting comment on whether a "conflict of interest" should include the appearance of a conflict or potential conflicts. In addition, noting that the disclosure requirements apply only to consultants, the SEC is requesting comment on whether they should be expanded to apply to other advisers as well.

No impact for current proxy season

The SEC is required to adopt new rules implementing Section 10C by July 16, 2011 and, under the proposal, once the final SEC rules are published in the Federal Register, the exchanges would have 90 days to propose new listing standards that comply with the new rules and one year to obtain final SEC approval of the new standards. In addition, the proposal clarifies that the compensation consultant and conflict-of-interest disclosures would not be required for proxy or information statements filed in definitive form before the effective date of the SEC's implementing rules. Accordingly, the proposed rules will not require any new or modified proxy statement disclosure during the current proxy season.

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