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SEC Proposed Rules: Compensation Committee-Related Requirements Under Dodd-Frank

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On March 30, 2011, the Securities and Exchange Commission ("SEC") issued proposed rules[1] to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[2] These proposed rules would implement new listing standards for compensation committee members, and add disclosure requirements related to the relationships between a compensation committee and compensation advisers. This article discusses these SEC proposed rules to provide a glimpse into future independence and disclosure requirements in the realm of executive compensation.

One important aspect of Dodd-Frank is the variety of new rules applicable to public reporting companies regarding corporate governance and executive compensation matters. These new requirements relate to say-on-pay votes, proxy access by shareholders in the election of directors, pay-for-performance disclosures, clawback policies, and compensation committee independence and use of compensation advisers. Of note, Dodd-Frank added new Section 10C to the Securities

[1] SEC Release No. 33-9199, File No. S7-13-11, *Listing Standards for Compensation Committees* (March 30, 2011), 76 Fed. Reg. 18,966 (April 6, 2011).

[2] Pub. L. No. 111-203 (July 21, 2010).

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Exchange Act of 1934 (the ''Exchange Act''). Section 10C requires that the SEC adopt rules:

- directing the national securities exchanges (the ''Exchanges'') and national securities associations to establish listing standards regarding compensation committee independence criteria and the retention and use of compensation consultants, independent legal counsel, and other advisers (''compensation advisers''); and
- regarding disclosure about the use of compensation consultants by compensation committees and conflicts of interest.

The proposed rules would add new Exchange Act Rule 10C-1 to implement the listing standard requirements, and amend existing Item 407 of Regulation S-K[3] to implement the heightened disclosure requirements regarding compensation consultants and conflicts of interest.

Compensation Committee Independence and Retention of Compensation Advisers

Compensation Committee Independence. Under Dodd-Frank Section 10C(a)(1), the SEC is directed to require Exchanges[4] to adopt listing standards to prohibit the listing of any equity security of an issuer, subject to exemptions discussed below, that is not compliant with the independence requirements for compensation committee members. Proposed rule 10C-1(b)(1)(i) would require each member of a listed issuer's compensation committee to be a member of the issuer's board of directors and to be independent. Each Exchange is directed to develop a definition of independence applicable to compensation committee members taking into account relevant factors, including:

- the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the company to such director; and
- whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer in a manner determined by the Exchange.[5]

Each Exchange may exempt particular relationships from the independence requirements, and in so doing the Exchange can consider the size of the issuer and any other relevant factors. The SEC did not provide any additional factors that the Exchanges must consider in developing such independence requirements, but did invite comment on whether any specific additional factors should be included in the final rule. Current Exchange listing standards already define the presence of certain relationships to preclude a finding of independence, such as recent or current employment of a director, or a member of his or her immediate family, by the issuer or the independent auditor, the presence of a material business relationship with the issuer, or a ''compensation committee interlock'' situation where the director is employed at another company where an executive officer of the issuer serves on the compensation committee. Under Section 301 of the Sarbanes-Oxley Act of 2002,[6] the SEC promulgated independence requirements relating to audit committee members that parallel the standards promulgated under these proposed rules. However, while proposed Rule 10C-1 requires that relevant factors be considered by the Exchanges in determining independence requirements, the Sarbanes-Oxley audit committee independence requirements expressly define certain relationships, the presence of which preclude a finding of independence.[7] Therefore, it appears the Exchanges are being provided with greater flexibility to determine the independence standards applicable to compensation committee members.

One area where there is potential for the independence requirements to differ as between audit committee members and compensation committee members is whether there should be a bar to an independence finding based on a relationship with a significant shareholder of the issuer. While such a relationship may be a bar to independence in the audit committee setting, some commentators have noted that directors affiliated with significant investors, such as private equity funds and venture capital firms, may be motivated to rigorously oversee compensation determinations in a manner that is more aligned with the interests of other shareholders than with management.

When Dodd-Frank was enacted, the SEC established a process that invited electronic and paper comments on Dodd-Frank provisions in advance of the issuance of proposed rules.[8] The comments received on Section 952 of Dodd-Frank from a number of commentators, such as the American Bar Association, Brian Foley & Company, Inc., Compensia, and Frederick W. Cook & Co., Inc., suggest that stock ownership alone should not automatically disqualify a board member from being considered independent for purposes of serving on a compensation committee.

Neither Dodd-Frank nor the Exchange Act defines the term ''compensation committee'' or includes a mandate that each issuer must have a compensation committee. The proposed rules do not add such requirement if an issuer does not currently have such a committee, but do direct the Exchanges to assure that the requirements will be applicable to any committee of the board, however named or characterized, that oversees executive compensation as part of its designated roles and responsibilities. There are practical reasons why most listed companies have established compensation committees. First, some Exchanges, such as the New York Stock Exchange, do generally require that a listed issuer either have a compensation committee or require that the independent directors of the Board separately determine, recommend, or oversee executive compensation matters.[9] The NASDAQ Stock Market requires executive compensation determinations to be made by either a compensation committee composed solely of

[3] Item 407 of Regulation S-K, 17 C.F.R. § 229.407.

[4] The proposed rules release indicates that while Dodd-Frank Section 10C(a)(1) also applies to national securities associations, the Financial Industry Regulatory Authority (''FINRA'') is the only national securities association registered with the SEC under Section 15A(a) of the Exchange Act and, because it does not list equity securities of any issuer, the proposed rules refer only to Exchanges.

[5] Proposed rule 10C-1(b)(1)(ii).

[6] Pub. L. 107-204, 116 Stat. 745 (2002).

[7] *See* SEC Release No. 33-8220, *Standards Relating to Listed Company Audit Committees* (April 9, 2003).

[8] The process organizes Dodd-Frank requirements by topic. See http://www.sec.gov/spotlight/regreformcomments.shtml.

[9] NYSE Listed Company Manual Section 303A.05.

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independent directors or by a majority of independent directors on the board in a separate vote.[10] Second, many companies rely on the exemption from short-swing liability under Section 16 of the Exchange Act by having all Section 16 officer and director equity compensation awarded by a compensation committee comprised solely of ''non-employee'' directors. Finally, Internal Revenue Code requirements under Section 162(m) require certain performance-based awards to be determined by a compensation committee composed of two or more ''outside directors.'' Each of these other statutory requirements have independence criteria included in the assessment. The SEC has requested comments as to whether the proposed approach is functional or whether the rule should be applied more broadly to either require listed issuers to have compensation committees or to apply the rule to individual directors outside of a committee structure.

Opportunity to Cure Defects Under the Listing Standards. In accordance with Dodd-Frank, the SEC's proposed rules provide that the Exchanges would be required to develop appropriate procedures for issuers to follow in order to have a reasonable opportunity to cure any defects that could lead to de-listing because of a failure to meet Exchange Act Section 10C requirements. Under the proposed rules, the Exchanges may 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 Exchange, may remain a member of the compensation committee until the earlier of the next annual meeting of the issuer or one year after the occurrence of the disqualifying event. While the SEC acknowledges that many Exchanges currently provide procedures to avoid immediate de-listing, the proposed rules seek to ensure that changes outside of a member's control receive at least a minimum amount of protection from de-listing.

Retention of Compensation Advisers. Additionally, the Exchanges are directed, under proposed Rule 10C-1(b)(2), to adopt listing standards providing that a compensation committee may, in its sole discretion, ''retain or obtain'' the advice of compensation consultants, independent legal counsel and other advisers, and to be responsible for the appointment, compensation, and oversight of any work of such compensation advisers. In addition, proposed Rule 10C-1(b)(3) requires that each issuer provide ''appropriate funding'' as determined by the compensation committee for payment of ''reasonable compensation'' to compensation advisers.

Neither Dodd-Frank nor the proposed rules require a compensation committee to always implement or act consistently with the advice imparted by such compensation advisers, or to impose any requirements that a compensation committee engage legal counsel independent from outside or in-house counsel to the issuer. A compensation committee must continue to use its own judgment in fulfillment of its duties.

Dodd-Frank does not require a compensation adviser to be independent, but does require the SEC to enumerate certain independence factors that must be considered by a compensation committee as it makes a determination to engage a compensation adviser. Section 10C(b) of the Exchange Act specifies that such independence factors must be competitively neutral and include, at a minimum:

- the provision of other services to the issuer by the person that employs the compensation adviser;
- the amount of fees received from the issuer by the person that employs the compensation adviser as a percentage of the total revenue of the person that employs the compensation adviser;
- policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts;
- any business or personal relationship of the compensation adviser with a member of the compensation committee; and
- any stock of the issuer owned by the compensation adviser.

The proposed rules repeat these Exchange Act Section 10C statutory requirements but do not impose any ''bright-line'' or materiality numerical thresholds to be used in making the independence assessment or add any additional independence factors. The SEC does invite the Exchanges to add additional independence factors, and requests comments as to whether additional factors would be useful. The requirement that these factors be ''competitively neutral'' has prompted a number of advance comments, and the SEC notes in the release that it assumes that this statutory language is intended to address concerns expressed by multi-service compensation consulting firms that conflicts of interest may also arise in the use of boutique consulting firms, because such boutique consulting firms may be significantly more dependent on revenues received from a smaller number of clients for more discrete, compensation-only, services.

Issuers Exempt From the Listing Standards. These listing standards would apply to issuers with listed equity securities on national securities exchanges and national securities associations. Therefore, issuers with their securities quoted on interdealer quotation systems, such as the OTC Bulletin Board and the OTC Markets Group, would not be impacted by these proposed rules. In addition:

- although not free from doubt given some inconsistencies in the Dodd-Frank statutory language, based on legislative history, the SEC's proposed rules will apply only to companies with equity securities listed on an Exchange or national securities association, not to debt securities; and
- the SEC is proposing to exempt security futures products from the reach of Rule 10C-1 by indicating that any national securities exchange registered as such solely pursuant to Section 6(g) of the Exchange Act and that lists and trades only security futures products would not be required to submit proposed rule changes to comply with SEC Rule 10C-1. The same exemption would apply to standardized options as well.

In keeping with the requirements of Dodd-Frank, the proposed rules provide the Exchanges with the authorization to exempt a particular relationship from the independence requirements applicable to compensation committee members, taking into account the size of the issuer and other relevant factors, and to authorize the Exchanges to exempt any category of issuer from the requirements of Exchange Act Section 10C. The poten-

[10] NASDAQ Listing Rule 5605(d).

tial impact on smaller reporting companies[11] is specifically mentioned.

Finally, under Exchange Act Section 10C(a)(1), the following five categories of issuers are not subject to the new compensation committee independence requirements:

- controlled companies,
- limited partnerships,
- companies in bankruptcy proceedings,
- open-end management investment companies, and
- foreign private issuers.

Procedures for Adoption of New Listing Standards The Exchanges are self-regulatory organizations and, under Section 19(b) of the Exchange Act, are required to propose rule changes to implement these new listing standards requirements for approval by the SEC. The standard of review states that the SEC shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations promulgated thereunder that are applicable to the self-regulating organization.[12] The SEC's proposed rules release indicates that such proposed rule changes will be required to include a review of whether and how existing or proposed listing standards satisfy the requirements of these proposed rules, a discussion of the Exchange's consideration of factors relevant to compensation committee member independence, and the definition of independence applicable to compensation committee members that the Exchange proposes to adopt in light of such review.

Compensation Consultant Disclosure and Conflicts of Interest

Section 10C(c)(2) of the Exchange Act requires that, in any proxy or consent solicitation material for an annual meeting (or special meeting in lieu of an annual meeting), each issuer must disclose whether:

- the compensation committee has retained or obtained the advice of a compensation consultant; and
- the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Rather than creating a new, separate disclosure rule to meet this requirement, the SEC is proposing to integrate these requirements into the proxy disclosure enhancements implemented by the SEC in December 2009 under Item 407 of Regulation S-K.[13] Under those enhanced proxy disclosure rules, issuers are currently required to disclose ''any role of compensation consultants in determining or recommending the amount or form of executive and director compensation,'' including:

- identifying the consultants;
- stating whether such consultants were engaged directly by the compensation committee or any other person;
- describing the nature and scope of the consultants' assignment, and the material elements of any instructions given to the consultants under the engagement; and
- disclosing the aggregate fees paid to a consultant for advice or recommendations on the amount or form of executive and director compensation and the aggregate fees for additional services if the consultant provided both and the fees for the additional services exceeded $120,000 during the fiscal year.

The SEC believes that the additional Dodd-Frank imposed requirements related to conflict of interest discussions fit naturally within the enhanced proxy disclosure rules, particularly because issuers have had two years of compliance with the existing disclosure requirements. As such, however, it is important to keep in mind that these disclosure requirements, once adopted, will apply to all issuers, without the exceptions for various types and categories of issuers described above under the listing standard requirements. In addition, the SEC has clarified that these disclosure requirements will be required only in proxy or consent solicitation materials for a meeting at which directors are to be elected.

The proposed rules would revise Item 407 somewhat, i.e., the current disclosure requirement with respect to compensation consultants is whether the consultant played ''any role'' in the issuer's process for determining or recommending the amount or form of executive or director compensation, whereas, under the Dodd-Frank requirement, this disclosure will need to include whether the compensation committee ''retained or obtained the advice'' of a compensation consultant. The SEC believes the practical effect of this change will be minimal. The proposed rules would add an instruction to Item 407 to clarify that ''obtained the advice'' of a compensation consultant relates to whether a compensation committee or management has requested or received advice from a compensation consultant, regardless of whether (1) there is a formal engagement of the consultant, (2) a formal client relationship exists, or (3) fees are paid for such advice.

With respect to conflicts of interest disclosure, the focus of current Item 407 is on compensation consultant fee disclosure. The proposed rules would expand that disclosure requirement to include any conflicts of interest and, if so, the nature of the conflict and how it is being addressed by the company. An instruction to Item 407 would direct issuers to the independence factors considered under the listing standards of the Exchange, as discussed previously, to assist the compensation committee in determining whether a potential conflict of interest exists. This also means that certain disclosure exemptions for compensation consultants that provide advice only with respect to broad-based plans, or that provide data only, may not be applicable to this conflicts of interest assessment.

If a compensation committee determines that there is a conflict of interest, the company will be required to disclose, in a clear, concise and understandable manner, the specific conflict and how it is being addressed. The SEC indicates that a general description of the company's policies and procedures to address conflicts or potential conflicts would not suffice.

[11] A smaller reporting company is generally a company with a public float of less than $75 million. Smaller reporting companies are subject to scaled down disclosure requirements.

[12] *See* Section 19(b)(2)(C) of the Exchange Act.

[13] *See* SEC Release No. 33-9089, *Proxy Disclosure Enhancements* (Dec. 16, 2009).

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The proposed revisions to Item 407 apply only to retaining or obtaining the advice of compensation consultants, not to the hiring of legal counsel or other advisers. The SEC has request comments as to whether the new disclosures should be applicable to all compensation advisers. The SEC also requested comments on whether smaller reporting companies should be exempted from these revised disclosure requirements.

Timing for Comments and Implementation

Comments on the proposed rules must be received by the SEC on or before April 29, 2011.

The provisions of Dodd-Frank require the SEC to issue final rules under Section 952 by July 16, 2011. Although Dodd-Frank generally requires that the new disclosure rules apply with respect to shareholder meetings occurring on or after July 21, 2011, the SEC has interpreted the statute such that these requirements shall not be applicable to proxy or consent solicitation materials until the effective date of the final rule. In addition, with respect to the listing standards, the Exchanges will be required to provide to the SEC proposed listing standard rule changes within 90 days after publication of the SEC's final rules, and to have such revised listing standards approved by the SEC no later than one year after publication of the final rules.

What Should Companies Do Now?

While the SEC has indicated recently that final rules on this topic are not expected to be effective until August to December 2011, there are some practical things that a public reporting company can begin to do now:

- *Determine whether the new listing requirements will apply*. Each company should determine whether the new Exchange listing standards are likely to apply, or whether an exemption will be applicable.
- *Review compensation committee composition.* If the new listing standards will apply, the company should review the composition of its existing compensation committee (if one is in place), and the impact, if any, the proposed independence factors could have.
- *Review compensation adviser retention process.* Similarly, each company should review its current policies and procedures with regard to retaining and using compensation advisers, referencing the factors and requirements of the proposed rules.
- *Review the potential for conflicts of interest.* Each company subject to the proxy disclosure rules (whether or not subject to the new listing standards) will need to review their current proxy disclosures to determine whether conflict of interest disclosures may be required and, if so, how the conflict will be, or is being, addressed.