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Alert Memo

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Dodd-Frank Corporate Governance Proposed Rules: Compensation Committee and Adviser Independence

On March 30, 2011, the U.S. Securities and Exchange Commission (the "SEC") released its proposed rules (the "Proposed Rules") implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 952 of the Dodd-Frank Act ("Section 952") added Section 10C to the Securities and Exchange Act of 1934 (the "Exchange Act") and contains a number of provisions generally relating to the independence of compensation committees and their advisers. This memorandum summarizes the Proposed Rules and provides a number of next steps for affected companies to begin to consider. As an initial matter, we note that comments on the Proposed Rules must be submitted to the SEC by April 29, 2011.

I. Major Components of Section 952

- Section 952 required the SEC to adopt rules requiring the national securities exchanges (the "Exchanges") to prohibit the listing of any security of an equity issuer that does not comply with listing rules regarding:
    - compensation committee member independence ("CC Independence Requirements") (see Section IV below),
    - a compensation committee's authority to engage (and pay for) compensation advisers ("CC Authority to Engage Compensation Advisers") (see Section V below) and
    - a compensation committee's consideration of certain relevant factors in selecting a compensation adviser ("CC Selection of Compensation Advisers") (see Section VI below).
- Section 952 also required the SEC to adopt rules regarding disclosure relating to a compensation consultant's conflicts of interest ("Compensation Consultant Conflicts of Interest Disclosure") (see Section VII below).

II. Timing of Implementation

- The Dodd-Frank Act required the SEC to issue rules directing the Exchanges to prohibit the listing of equity issuers not in compliance with Section 10C of the Exchange Act no later than July 16, 2011. It appears that the SEC intends to publish the final version of the Proposed Rules (the "Final Rules") by that date.

- The Proposed Rules would require each Exchange to propose rules or rule amendments that comply with the Final Rules no later than 90 days, and to adopt final rules or rule amendments no later than one year, after the publication of the Final Rules in the Federal Register.

- For Compensation Consultant Conflicts of Interest Disclosure, the Proposed Rules contemplate that these new requirements would apply to definitive proxy statements filed for annual meetings at which directors will be elected on or after the effective date of the Final Rules.

III. Who is Covered by the Proposed Rules

The Proposed Rules generally apply only to issuers of equity securities listed on an Exchange, except that the Compensation Consultant Conflicts of Interest Disclosure applies to issuers of equity securities registered under the Exchange Act, regardless of whether such securities are listed on an Exchange.[1]

- Section 952 exempted from the CC Independence Requirements (1) controlled companies, (2) limited partnerships, (3) companies in bankruptcy, (4) open-ended management investment companies and (5) foreign private issuers that provide annual disclosure of the reasons why they do not have an independent compensation committee (for a more detailed discussion of these exemptions, see Section IV below).

- Controlled companies are also exempt from the requirements under CC Authority to Engage Compensation Advisers and CC Selection of Compensation Advisers.

- Issuers of debt securities only are not subject to any of the Proposed Rules.

- Foreign private issuers are generally subject to the Proposed Rules, except that those that disclose in their annual reports the reasons they do not have an independent

[1] The SEC proposes to exempt security futures products and standardized options from the requirements of Rule 10C-1 (listing standards relating to compensation committees). As a result, to the extent the Final Rules exempt the listing of security futures products from the scope of Rule 10C-1, a national securities exchange registered solely pursuant to Section 6(g) of the Exchange Act and that lists and trades only security futures products would not be required to file a rule change in order to comply with Rule 10C-1.

compensation committee are exempt from the CC Independence Requirements (see Section IV below).[2] We note that the Exchanges have generally exempted foreign private issuers from their corporate governance requirements, instead deferring to home country rules or practices. For example, foreign private issuers listed on the New York Stock Exchange ("NYSE") are not subject to the following NYSE listing standards: (i) that a listed company board is comprised of a majority of independent directors, (ii) that a listed company compensation committee is comprised entirely of independent directors and (iii) that a listed company adopt and disclose corporate governance guidelines. Similarly, NASDAQ exempts foreign private issuers from its corporate governance requirements including: (i) that a listed company's board is comprised of a majority of independent directors and (ii) that compensation for executive officers is determined by a majority of independent directors of the board or an independent compensation committee. We note that while under the Proposed Rules, certain foreign private issuers are subject to the CC Independence Requirements and all foreign private issuers are subject to the other new listing standards, the Exchanges have similarly broad exemptive authority with respect to the new listing standards.

IV. Compensation Committee Independence Requirements (Proposed Rule 10C-1(b)(1))

Definition of Independence

Independence Factors. To implement the CC Independence Requirements, the Proposed Rules would require each member of a listed issuer's compensation committee to be (i) a member of the issuer's board of directors and (ii) "independent."

The Proposed Rules do not define independence for these purposes, but instead direct the Exchanges to establish a definition taking into account relevant factors, including the following factors taken from Section 952:

- the sources of a compensation committee member's compensation (including consulting, advisory or other compensatory fees paid to the compensation committee member by the issuer) and

- whether the compensation committee member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

[2] As previously noted in our Alert Memo entitled *Not Just Financial Reform: Dodd-Frank's Executive Compensation and Governance Requirements for All Public Companies* (available at http://www.cgsh.com/not_just_financial_reform_dodd-franks_executive_compensation_and_governance_requirements_for_all_public_companies/) (the "Dodd-Frank Executive Compensation Alert Memo"), we note that foreign private issuers are not subject to most of the other executive compensation and corporate governance provisions of the Dodd-Frank Act.

The foregoing factors are drawn from Section 10A(m) of the Exchange Act, which mandates specific independence requirements for audit committees of listed companies. While the SEC stated in the Proposed Rules that the Exchanges might consider simply picking up the flat prohibitions found in Section 10A(m) in their compensation committee independence standards, it also made clear that Section 952 and the Proposed Rules provide flexibility for the Exchanges to establish their own minimum criteria for compensation committees and that the two committees do not necessarily share the same independence concerns. By way of example, the SEC noted that while directors affiliated with significant shareholders cannot serve on audit committees, such a bright-line rule may be inappropriate for compensation committees.[3]

The Proposed Rules do not identify additional factors to be considered, though the SEC is soliciting comments as to whether additional factors should be included in the Final Rules. Among the requests for comment, the SEC asks whether issuers should be required to consider as potentially relevant factors in making the independence determination (1) business or personal relationships between a compensation committee member and (2) an executive officer or board interlocks and the employment of a director at an issuer's compensation peer group company.

The SEC concluded that it is unnecessary to create any safe harbors for particular relationships between members of a compensation committee and an issuer, as were incorporated into the audit committee mandatory independence requirements, but acknowledged that the Exchanges may exempt particular relationships in their discretion.

Under the Proposed Rules, the Exchanges may specify other factors to be considered in compensation committee independence determinations, as each deems appropriate, subject to approval by the SEC pursuant Section 19(b) of the Exchange Act. Before approving the Exchanges' proposed rule changes, the SEC will consider whether the factors identified in Section 952 as relevant to an independence determination were considered by the Exchanges, and whether their proposed rule changes are consistent with the requirements of Section 6(b) of the Exchange Act.

Independence Determination. The Proposed Rules provide that independence should be evaluated based on current relationships between a compensation committee member and an issuer. However, the SEC is soliciting comments on whether there should be a look-back period with respect to relationships existing before a member of the compensation

[3] When the Dodd-Frank Act was enacted, we noted in the Dodd-Frank Executive Compensation Alert Memo that it was unclear how the independence requirements of Section 952 would impact private equity companies who have authority to appoint a director to the board of its portfolio company. The SEC's observation that affiliated directors may warrant different treatment under the compensation committee and the audit committee independence rules suggests that the SEC believes that directors affiliated with private equity firms who are major shareholders of an issuer (which does not qualify for the "controlled company" exemption) should not be categorically prohibited from serving on the compensation committees of such issuers.

committee is appointed, including whether the look-back period for compensation committee members currently serving should begin prior to the effective date of the new listing standards. While the SEC noted that the Exchanges currently incorporate look-back periods into their definitions of independence for board members, we highlight that, as the SEC acknowledges in its release, Rule 10A-3, governing listing standards relating to audit committees, does not include a look-back period for audit committee member independence determinations.

Committees Subject to the CC Independence Requirements

The Proposed Rules would apply to a listed issuer's compensation committee, or if there is no such committee designated, to any other board committee (regardless of its official designation) that performs duties routinely performed by a compensation committee. The Proposed Rules would not require issuers to have a compensation committee, and instead defer to the applicable Exchange's current listing standards. Under the Proposed Rules, individual directors responsible for a compensation committee's typical duties are not subject to the independence requirements. So while the CC Independence Requirements would apply to all companies listed NYSE due to NYSE's requirement that listed issuers have a compensation committee, issuers that avail themselves of the NASDAQ Stock Market's rule allowing a majority of a board's independent directors to oversee compensation would not be subject to these requirements.[4] In a request for comment, the SEC has asked whether the CC Independence Requirements should apply to individual members of a board of directors who are tasked with overseeing compensation.

Entities Exempt from the CC Independence Requirements

Section 952 exempts the following entities from the compensation committee independence requirements. The Proposed Rules seeks to clarify the scope of the exemptions.

- *Controlled companies.* The Proposed Rules incorporate Section 10C(g)(2) of the Exchange Act's definition, which defines a "controlled company" as an issuer that is listed on an exchange and holds an election for its board of directors in which more than 50% of the voting power is held by an individual, a group or another issuer.

- *Limited partnerships.* The Proposed Rules do not define "limited partnerships." The SEC noted that there is a general understanding that a limited partnership is a form of business ownership and association comprised of one or more general partners with unlimited liability and one or more limited partners with liability limited to the amount of their investment.

[4] The SEC noted its understanding that less than 2% of NASDAQ listed issuers opt for this alternative.

- *Companies in bankruptcy proceedings.* The Proposed Rules do not define "companies in bankruptcy proceedings." The SEC is soliciting comments as to whether the term should be defined.

- *Open-ended management investment companies registered under the Investment Company Act of 1940.* The Proposed Rules reference the definition in Section 5(a)(1) of the Investment Company Act -- an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer.

- *Certain foreign private issuers.* A foreign private issuer that discloses in its annual report the reasons why it does not have an independent compensation committee is exempt from the CC Independence Requirements.

    - Exchange Act Rule 3b-4 defines "foreign private issuer" as any "foreign issuer other than a foreign government, except for an issuer that has more than 50% of its outstanding voting securities held of record by U.S. residents and any of the following: a majority of its officers and directors are citizens or residents of the United States, more than 50% of its assets are located in the United States, or its business is principally administered in the United States." As the definition applies to all Exchange Act rules, the SEC stated that it thought it unnecessary to provide for an explicit cross-reference in the Proposed Rules.

    - The SEC noted that some foreign private issuers have two-tier boards, with each designated as either a management board or a supervisory or non-management board. The Proposed Rules clarify that for foreign private issuers that are subject to the CC Independence Requirements and who have two-tier boards, the CC Independence Requirements would apply to a separate compensation committee formed by the supervisory or non-management board.

Cure Provisions

Section 952 requires that there be a reasonable opportunity to cure violations of the Exchanges' listing standards before an issuer is delisted or prohibited from being listed. The SEC noted that the Exchanges' existing cure provisions would satisfy this requirement. In general, these cure provisions provide that issuers that fall below NYSE's and NASDAQ's continued listing criteria have the opportunity to submit for approval a plan that is reasonably expected to bring the issuer into compliance.

For violations of the CC Independence Requirements, Proposed Rule 10C-1(a)(3) adopts the cure provisions applicable to audit committee independence requirements under

Section 10A(m) of the Exchange Act. Specifically, if a compensation committee member ceases to be independent for reasons beyond such member's control, such member may, with notice by the issuer to the applicable Exchange, remain on the compensation committee until the earlier of (a) the next annual meeting and (b) one year from the date of the event that caused such member to no longer be independent.

V. Compensation Committee Authority to Engage Compensation Advisers (Proposed Rule 10C-1(b)(2), (3))

The Proposed Rules implements Section 952's provisions regarding compensation committees' authority to engage compensation advisers without any changes. The provisions require a listed issuer to give its compensation committee the authority, exercised in its sole discretion, to retain or obtain an independent compensation consultant, legal counsel or other adviser (each, a "compensation adviser") and to provide the compensation committee with sufficient funding for such retention.

VI. Compensation Committee Selection of Compensation Advisers (Proposed Rule 10C-1(b)(4))

Requirements

Section 952 also provided that a compensation committee must consider certain relevant factors identified by the SEC when selecting a compensation adviser to the compensation committee.

Section 10C(b) of the Exchange Act provides that while a compensation adviser is not required to be independent, a listed company's compensation committee must undertake an evaluation of a compensation adviser's independence during the selection process. In the preamble to the Proposed Rules, the SEC emphasized that a compensation committee may retain non-independent legal counsel and use in-house counsel or outside counsel retained by the issuer or management and is not required to hire "independent legal counsel." Though not made entirely clear by the Proposed Rules, it appears a compensation committee will need to consider the independence of any adviser from which it obtains advice, including in-house counsel and outside counsel retained by the issuer or management.

Proposed Rule 10C-1(b)(4) repeats the factors listed in Section 952 as those relevant to a determination of a compensation adviser's independence and notes that determining which factors are relevant in a given case requires consideration of the particular facts and circumstances. The factors include:

- whether a compensation adviser's employer provides other services to the issuer,
- the amount of fees the compensation adviser's employer receives from the issuer as a percentage of such employer's total revenues,

- the compensation adviser's policies and procedures to prevent conflicts of interest,
- business or personal relationships between a compensation adviser and any member of the issuer's compensation committee and
- the compensation adviser's stock ownership in the issuer.

Given that the factors are for consideration only, and are not standards for independence, the Proposed Rules do not provide for any materiality or bright-line thresholds. The Proposed Rules do, however, provide the Exchanges with the discretion to add other independence factors that must be considered by a compensation committee of a listed issuer.

The SEC is soliciting comments on whether Regulation S-K of the Exchange Act should be amended to include disclosures relating to a compensation committee's process for selecting compensation advisers under the new listing standards. In order to comply with Section 952's requirement that the factors to be considered be "competitively neutral", the SEC has also requested comments on how this determination should be made.

VII. Compensation Consultant Conflicts of Interest Disclosure (Proposed Amendment to Item 407(e)(3) of Regulation S-K)

Integration with Item 407(e)(3) of Regulation S-K

The Proposed Rules require disclosures relating to a compensation consultant's conflicts of interest. The SEC noted that Item 407(e)(3)(iii) of Regulation S-K currently requires registrants subject to the proxy rules set forth in Section 14A of the Exchange Act to disclose certain information relating to the engagement of compensation consultants. However, while Item 407(e)(3) focuses on disclosure relating to conflicts that may arise when a compensation consultant also provides other services to an issuer, Section 952 requires disclosure regarding conflicts of interest that may be raised by a compensation consultant's work or other relationships with the committee or the issuer more broadly. In the Proposed Rules, the SEC chose to integrate the Compensation Consultant Conflicts of Interest Disclosure with existing Item 407(e)(3) disclosure requirements and is soliciting comments on whether they should be combined, as proposed, or whether separate disclosure requirements are appropriate. Moreover, although Section 952 clearly provided for the additional disclosure only with respect to compensation consultants, the SEC is requesting comments on whether the Final Rules should be extended to other compensation advisers, including, for example, independent legal counsel.

Conflicts of Interest Disclosures

Section 10C(c)(2) of the Exchange Act directs Exchanges to require listed issuers to disclose, in accordance with the SEC's regulations, in any proxy or consent solicitation for an annual meeting:[5]

- whether the compensation committee has retained or obtained the advice of a compensation consultant,
- whether the compensation consultant's work has raised any conflicts of interest,
- if a conflict of interest has arisen, the nature of such conflict of interest and
- how such conflict of interest is being addressed.

Current Item 407(e)(3)(iii) requires registrants to disclose "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation," including by identifying the consultant, indicating whether such consultant was engaged by the compensation committee, describing the assignment and any instructions, and disclosing aggregate fees paid for consulting services relating to compensation and the fees paid for other services, if the fees for such other services exceeded $120,000 during the fiscal year.

Under current Item 407(e)(3), exclusions from disclosure apply for consulting services:

- relating to broad-based plans that do not discriminate in favor of executives or directors,
- that do not provide customized information for a particular registrant or
- that are customized, but not based on criterion set by the compensation consultant, if no related advice is provided by the compensation consultant.

Under the Proposed Rules, these exclusions would not apply to the Compensation Consultant Conflicts of Interest Disclosure but would continue to apply to the existing disclosure required under Item 407(e)(3). The SEC is soliciting comments on whether the exclusions should apply to the Compensation Consultant Conflicts of Interest Disclosure or be eliminated from the Item 407(e)(3) disclosures.

[5] As discussed below, the Proposed Rules clarify that these disclosures are only required at annual meetings at which directors are to be elected.

Registrants Subject to the Disclosure

Under the Proposed Rules, the combined disclosure requirement would apply to Exchange Act registrants subject to the proxy rules, regardless of whether such registrant is or is not listed on an Exchange, and regardless of whether it is or is not a controlled company (despite the language of Section 952). The SEC is soliciting comments on whether the requirement should extend to unlisted registrants and controlled companies, as proposed, and whether Exchange Act Forms 20-F and 40-F should be amended to require disclosure by foreign private issuers not subject to the proxy rules.

When Disclosure is Required

The Proposed Rules clarify that the Compensation Consultant Conflicts of Interest Disclosure need only be made in connection with a meeting at which directors will be elected. The combined disclosure is required when a compensation committee "retains or obtains" the advice of a compensation consultant, without consideration of whether a formal engagement or relationship exists or whether any fees are paid for such advice. While other disclosure requirements of Item 407(e)(3) would be unchanged, under the Proposed Rules, the fee disclosure requirements would now be triggered if either management or the compensation committee "retains or obtains" a compensation consultant's advice. In analyzing whether a conflict of interest that requires disclosure exists, the Proposed Rules direct a registrant to consider the factors identified as relevant to the selection of a compensation adviser in Compensation Committee Selection of Compensation Advisers (see Section VI above).

The SEC is soliciting comments on whether disclosure should also be triggered by the "appearance" of a conflict of interest or by a potential conflict of interest.

VIII. Next Steps

Based on the provisions of the Proposed Rules, we suggest that issuers subject to the new listing or disclosure requirements begin to consider the following next steps in the event the Final Rules are adopted in substantially the same form as the Proposed Rules:

- Implementing a new, or updating an existing, written policy to address independence determinations for members of the compensation committee (whether current or prospective), including a consideration of the factors identified as relevant in the CC Independence Requirements and any additional considerations deemed relevant by the applicable Exchange, including documentation of the independence evaluation process as it relates to each prospective and current member of the compensation committee (e.g., detailing in board minutes the factors considered and determinations made for each current and prospective committee member).

- Evaluating the independence of current members of the compensation committee and beginning to make preparations, subject to the Final Rules and related Exchange rules, to replace members who are determined to not be independent (including through utilization of cure provisions).

- Updating director and officer questionnaires to reflect the factors identified in the CC Independence Requirements and any additional considerations deemed relevant by the applicable Exchange.

- Reviewing compensation committee charters to ensure the committee has the necessary authority and budget to engage compensation advisers.

- Implementing new, or updating existing, written policies for analyzing the independence of compensation advisers, including a consideration of the factors identified as relevant to the compensation committee selection of compensation advisers and any additional considerations deemed relevant by the applicable Exchange. Such policies should include appropriate measures for documenting the evaluation processes as they relate to each prospective independent compensation adviser (e.g., detailing in board minutes the independence factors considered and determinations made for each compensation adviser).

- Implementing new, or updating existing, written policies for analyzing whether conflicts of interest exist for compensation advisers, including a consideration of the factors identified as relevant to compensation consultant conflicts of interest and any additional considerations deemed relevant by the applicable Exchange. Such policies should include appropriate measures for documenting the evaluation processes as they relate to each compensation adviser and potential conflicts of interest (e.g., detailing in board minutes the factors considered and determinations made for each compensation adviser in respect of potential conflicts of interest).

- Requiring advisers to the compensation committee to complete a questionnaire incorporating factors identified as relevant to the compensation committee selection of compensation advisers, including, for example, a compensation adviser's equity ownership in the registrant and any conflicts of interest policies of a compensation adviser's employer.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Corporate Governance" or

"Executive Compensation and ERISA" under the "Practices" section of our website at http://www.clearygottlieb.com.

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