

SEC Proposed Rules on Compensation Committee and Consultant/Adviser Independence

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On March 30, 2011, the Securities and Exchange Commission (SEC) proposed rules directing the national securities exchanges to adopt listing standards related to the Compensation Committee and Consultant independence requirements of the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (Dodd-Frank). In addition, the SEC has proposed new requirements for disclosures regarding consultants and conflicts of interest.

The proposed rules are generally consistent with expectations and reflect a straight-forward application of Dodd-Frank. Much of the implementation of this aspect of Dodd-Frank will actually be accomplished through the listing standards adopted by the national securities exchanges, subject to approval by the SEC. For the most part, where there was ambiguity in how to interpret Dodd-Frank’s language, the SEC has passed the responsibility for interpretation on to the national securities exchanges or has let the Dodd-Frank language stand, but solicited comments on whether further clarification is necessary.

The SEC is soliciting comments on a number of aspects of the proposed rules, with a deadline for any comments of April 29, 2011. Below is a summary of the key provisions of the proposed rules based on a review of the full text and accompanying press release. We also provide our own comments on some of the key areas where the SEC is seeking input.

Listing Standards and Compensation Committee Independence

One of the objectives of Dodd-Frank was to ensure the independence of the Compensation Committee. To promote this objective, Dodd-Frank requires that national securities exchanges adopt listing standards to address the following issues:

- **Require that Compensation Committee members be independent.** Factors that need to be considered in assessing independence include:
 - Sources of compensation of a director, including any consulting, advisory or compensatory fee paid by the company to such member of the board of directors
 - Whether a member of the board of directors of a company is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company
 - **CAP Comment:** *The SEC is seeking comments on aspects of this rule including whether they should require minimum independence standards for all exchanges beyond consideration of the two factors above and whether the standards should be based on current relationships only or have a “look back” period. It will be interesting to see if the listing standards converge to a consistent standard or if slight differences remain*
- **Authority and Funding of the Compensation Committee** – Listing standards need to indicate that the Compensation Committee has the authority to obtain a compensation adviser, is directly responsible for the adviser and must be appropriately funded to pay for the adviser
 - **CAP Comment:** *This aspect of the rule is more straightforward, but the SEC is seeking comments*

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on technical aspects related to use of legal advisers including the definition of an “independent legal counsel” and the potential need for clarification around the use of in-house legal counsel or the company’s outside counsel. In addition, they are seeking comments on what the typical administrative expenses for Compensation Committees are and whether a provision requiring funding of such expenses would be helpful

- **Compensation Adviser Selection:** Listing standards must state that the Compensation Committee may select a compensation consultant, legal counsel or other adviser only after considering the following five factors:
 - Other services provided to the company by the adviser
 - Compensation adviser fees from company as a % of total fees
 - Compensation consulting firm’s conflict of interest policies and procedures
 - Business or personal relationships between compensation adviser and members of the Compensation Committee
 - Compensation adviser’s ownership of company stock
 - **CAP Comment:** *In the proposed rules, the SEC did not choose to expand the number of factors to be considered beyond the original five specified in Dodd-Frank. The SEC is soliciting comment on the competitive neutrality of the five factors, potential additions to the factors to consider, and multiple issues for potential clarification (e.g., does adviser refer to the firm or individual providing services?, should there be specific tests/thresholds applied to the five factors?)*
- **Exemptions:** The proposed rules require the exchanges to exempt the following five categories of companies from the Compensation Committee independence requirements:
 - Controlled companies
 - Limited partnerships
 - Companies in bankruptcy proceedings
 - Open-end management investment companies
 - Foreign private issuers that disclose in annual report why they do not have an independent Compensation Committee
 - Note: The proposed rules would authorize exchanges to exempt certain types of relationships or classes of companies from the independence requirements, subject to SEC approval
 - **CAP Comment:** *The SEC is soliciting comments on whether certain types of companies (e.g., smaller reporting companies, recent IPOs) should be exempt from the rules or provided with additional time to comply*

Compensation Conflicts of Interest Disclosure

The proposed rules will build on the existing disclosure requirements but also require additional disclosure about whether:

- The Compensation Committee has retained or obtained the advice of a Compensation Consultant
- 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
- The proposed rules would eliminate the current disclosure exception for services that are limited to

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consulting on broad-based plans and the provision of non-customized benchmark data, but retain the current fee disclosure requirements, including the exemptions from those requirements

- **CAP Comment:** *The SEC is soliciting comments on key aspects of this issue, including whether or not they should attempt to clarify what a “conflict of interest” that must be disclosed is. Another area where they are seeking input is on whether any information related to the five factors under consideration needs to be disclosed*

Conclusion

For most of these rules, the impact will be through the new listing standards for the national securities exchanges rather than directly through the SEC’s regulations. For larger companies, Compensation Committee member independence will likely be a non-issue as most already have Compensation Committees made up of all independent directors and it is unlikely that the new listing standards will make the independence requirements significantly more stringent.

On adviser independence, we expect that the outcome will be that companies will likely operate within the general guidance provided by the five factors. Companies will need to develop a process to conduct a review of the five factors and come to their own conclusions about whether or not there is a conflict of interest. Companies may choose to say they evaluated the principles and determined the adviser to be independent. Other may go into more elaborate detail about the process and determination similar to the way companies have addressed the disclosure of risk assessment in compensation.

Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.