

SEC Proposes Independence Rules for Compensation Committees and Advisers

On March 30, 2011, the SEC [proposed rules](#) to implement the Dodd-Frank Act's requirements regarding the independence of compensation committees and their advisers. There is little to report because the SEC stayed very close to the requirements of the statute, declined to impose additional measures and delegated to the national securities exchanges the work of developing their own rules. As a result, companies will not be able to assess the impact of the rules on their compensation committees and advisers until the exchanges propose their listing standards. The exchanges will have 90 days from the publication of the final rules in the Federal Register to propose listing standards implementing the rules.

As an overview of the rulemaking process, the framers of Dodd-Frank cited certain factors that listed company boards should be required to consider (a) in determining the independence of their compensation committee members and (b) when selecting advisers. The statute directs the SEC to propose rules, which act as baseline expectations of listing standards, for the national securities exchanges to implement. The SEC has requested public feedback, and after considering the comments received, will issue final rules. The exchanges must then, within 90 days from the publication of the final rules in the Federal Register, propose listing standards implementing the SEC rules. The SEC will likely work with the exchanges on those standards, which the SEC must approve. The proposed rules released by the SEC this week are only the start of this process.

Compensation Committee Member Independence

The baseline set in the SEC's proposed rules would continue to leave to the board the ultimate determination as to the independence of compensation committee members. It will be up to the exchanges in proposing listing standards to determine how the following factors, which are the essential factors originally cited by Dodd-Frank, along with other factors that the exchanges add, should be considered in evaluating the independence of compensation committee members:

- the source of compensation of a member of the board of directors, including any consulting, advisory or other compensatory fees paid by the issuer; and
- whether a member of the board of directors has an affiliate relationship with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

Under the proposed rules, the SEC emphasizes that these are factors for consideration, not bright-line prohibitions of the sort that are mandated for audit committee members pursuant to the Sarbanes-Oxley Act. The proposed rules therefore permit discretion by the exchanges in establishing their own independence criteria and determining how these factors should be considered, including whether or not they should act as blanket prohibitions and whether other relationships or factors may or may not be relevant. For example, the SEC observes the possibility that, while a member of an issuer's compensation committee who is affiliated with a significant shareholder (*e.g.*, a private equity fund) may not be considered independent for audit committee purposes, such a blanket prohibition may not be appropriate for compensation committees.

The proposed rules clarify that listed companies are not required to have a compensation committee, unless otherwise required by the applicable exchange.

Controlled companies (*i.e.*, companies owned 50% or more by a single investor or group of investors) are expressly exempt from complying with this requirement, and the exchanges are permitted to establish other exemptions.

Advisers to Compensation Committees

The proposed rules provide that compensation committees may retain compensation consultants and other advisers after taking into account the independence of the advisers. Compensation committees are not precluded from retaining the company's advisers. Compensation committees will, however, be directly responsible for the selection, compensation and oversight of the advisers they choose to engage. Issuers must provide funding for the retention of these advisers.

The proposed rules simply repeat the Dodd-Frank list of five factors that compensation committees must use in evaluating independence, along with any additional factors that the exchange may require:

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

The SEC declined to adopt any materiality or bright-line thresholds or cut-offs with respect to these factors.

As with the proposed rule relating to compensation committee member independence, controlled companies are expressly exempt from complying with this requirement, and the exchanges are permitted to exempt other categories of issuers.

Disclosure of Use of Compensation Consultants

The SEC's proposed rules also include disclosure requirements relating to the use of compensation consultants. These would be standard SEC rules and are not subject to the exchange rulemaking process described above.

Dodd-Frank requires disclosure of:

- whether the compensation committee has obtained or retained the advice of a compensation consultant;
- whether the use of a compensation consultant raised any conflict of interest; and
- if there is a conflict of interest, the nature of the conflict and how the registrant is addressing the conflict.

To effectuate this requirement, the SEC proposes to modify the existing disclosure requirement under Item 407(e) of SEC Regulation S-K so that disclosure in the company's annual proxy statement would be required whenever an issuer's compensation committee "retained or obtained" the advice of a compensation consultant, regardless of whether a formal engagement or client relationship exists between the consultant and the committee or management, and irrespective of any fees being paid. The proposed rules regarding conflicts of interest also apply to compensation consultants who only consult on broad-based plans that are generally available to all salaried employees or who only provide information that is not customized, although the exemption from certain fee disclosure for these consultants remains.

The SEC declined to define the sort of “conflicts of interest” that would trigger the disclosure. Instead, issuers must look to the facts and circumstances of the engagement in determining whether a conflict exists, including considering at minimum the five statutory independence factors plus any other factors mandated by the exchanges. The disclosure must discuss the specific conflict; a description of the issuer’s policies and procedures to address conflicts of interest is not sufficient.

Application of Rules to Certain Types of Companies

Foreign Private Issuers

Foreign private issuers that disclose in their annual reports the reasons that they do not have an independent compensation committee are exempt from the compensation committee independence requirements. Foreign private issuers are generally exempt from the proxy rules and therefore will not be required to provide the new disclosure relating to the use of compensation consultants. Otherwise, unless specifically exempted by the exchanges, foreign private issuers are subject to the proposed rules. Because the exchanges have the authority to exempt any category of issuers, they may choose to exempt foreign private issuers.

Newly Public Companies

The proposed rules do not provide newly public companies with any additional time to comply with the independence and disclosure requirements. The SEC has requested comments on whether additional time should be permitted.

Timeline

- Comments are due to the SEC by **April 29, 2011**.
- Dodd-Frank requires the SEC to issue final rules no later than July 16, 2011 directing exchanges to prohibit the listing of any security of an issuer that is not in compliance with the independence requirements related to compensation committees and their advisers.
- National securities exchanges will have 90 days following the publication of the SEC final rules in the Federal Register to provide the SEC with their proposed rules, which must be approved by the SEC.
- National securities exchanges will need to have final rules within one year after the SEC final rules are published in the Federal Register.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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