

Akerman Practice Update

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SEC Proposes Rules Implementing Dodd-Frank Provisions on Compensation Committee Independence

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On March 30, 2011, the U.S. Securities and Exchange Commission (the "Commission") issued proposed rules to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The Dodd-Frank Act amended the Securities Exchange Act of 1934 (the "Exchange Act") to add new Section 10C to the Exchange Act dealing with compensation committees. Under the Dodd-Frank Act, the Commission must, by rule, direct national securities exchanges (such as the NYSE and NASDAQ Stock Market) to adopt certain listing standards addressing the independence of the members of compensation committees and their selection of advisors. The proposed rules also revise applicable disclosure requirements relating primarily to the use of compensation consultants and with respect to conflicts of interest. The proposed rules can be found [here](#).

The proposed rules largely mirror the provisions of Section 952 of the Dodd-Frank Act and leave it up to the exchanges to add more specific or additional listing requirements as they deem appropriate, although the Commission



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reserves the final word since it must ultimately approve the listing standards promulgated by the exchanges. The Dodd-Frank Act requires that the new rules be issued by no later than July 16, 2011 and for the exchanges to have final rules issued by no later than 90 days after publication of the Commission's final rules. Public comment on the Commission's proposed rules is required by April 29, 2011.

Compensation Committee Independence

Under proposed Rule 10C-1, each exchange will be required to adopt rules prohibiting the listing of an issuer whose compensation committee was not made up entirely of members of its board of directors who are "independent." The definition of "independent" is left up to the particular exchanges to define, provided that they must take into account the following "relevant factors" that are enumerated in the Dodd-Frank Act:

- the source of compensation for a director, including any consulting, advisory, or compensatory fees paid by such issuer to the director; and
- whether such director is affiliated with the issuer, a subsidiary of the issuer, or is an affiliate of a subsidiary of the issuer.

Unlike the rules regarding which directors may serve on audit committees under Section

10A(m) of the Exchange Act, listing exchanges will have some discretion in establishing minimum independence criteria for members of compensation committees. For example, the exchanges might determine that directors who are affiliates of major stockholders may meet the independence standards for compensation committees even if they do not meet the standards for serving on an audit committee. Further, the proposed rules will only apply to listing standards for companies whose equity securities are listed on an exchange.

The proposed rules do not require listed companies, if not already required by an exchange to establish a compensation committee, to do so. For example, the NYSE currently requires listed issuers to have compensation committees composed solely of independent directors and to assign executive compensation-related tasks to such committee. Conversely, the NASDAQ Stock Market does not mandate compensation committees, but requires that executive compensation to be determined or recommended to the board of directors for determination by either a compensation committee comprised solely of independent directors or by a majority of the independent members of the board of director. Under the proposed rules, the new independence standards as to the make-up of the compensation committees would

apply to any committee of directors charged with making decisions about executive compensation, regardless of whether such committee is called a "compensation committee." For example, the proposed rules would apply to the nominating and corporate governance committee of a company where that committee has been assigned compensation-related tasks.

The proposed rules request comment as to whether the final rules should require other "independence" factors to be considered such as business or personal relationships between a director and an executive officer, board interlocks and employment of a director at a peer-group company.

In conformity with Section 952 of the Dodd-Frank Act, the proposed rules include several categories of companies that are expressly exempt from the application of the independence standards of the proposed rules. They are: (i) controlled companies, (ii) limited partnerships, (iii) companies in bankruptcy proceedings, (iv) open-end management investment companies registered under the Investment Company Act of 1940, and (v) any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee. Controlled companies are defined as listed companies as to which more than 50 percent of the voting power with respect to an

election for the board of directors is held by an individual, a group, or another issuer.

Under the proposed rules, the exchanges are permitted to exempt particular relationships from the independence requirements, as each exchange determines is appropriate, taking into consideration the size of the issuer and any other relevant factors. For example, an exchange might grant smaller reporting companies or newly public companies an exemption or a deferral from the application of the proposed rules (subject to the Commission's overriding power to approve or disapprove the exchange's rules in that regard). One issue that will likely be on the table during the comment period is whether the Commission should consider creating a blanket exemption from the rules for smaller reporting companies or a deferral from the application of the rules for newly public companies. While the Commission chose not to include such provisions in the proposed rules, it is clear that one or more of the commissioners may push for consideration of such a provision in the final rules.

Compensation Advisers

Under the Dodd-Frank Act, the compensation committee of a listed issuer may, in its sole discretion, retain the advice of a "compensation

consultant." Further, the Dodd-Frank Act requires that compensation committees also have the right to retain independent legal counsel and other advisors. Additionally, the Dodd-Frank Act provides that compensation committees must be afforded the sole discretion to appoint, compensate and oversee the work of compensation consultants, legal counsel and other advisors ("compensation advisors") and that issuers are obligated to provide "appropriate funding," as determined by the compensation committee, for the payment of "reasonable compensation" to the compensation advisors. The proposed rules implement these requirements.

The proposed rules, in conformity with the requirements of the Dodd-Frank Act, require that exchange listing standards include provisions that require the compensation committee to consider the independence of the advisor before selecting the advisor. The provisions of the Dodd-Frank Act specify that the independence factors identified by the Commission to be considered by the compensation committee before it retains a compensation advisor must be "competitively neutral" and must include, at a minimum, consideration of the following five independence factors:

- whether the entity employing the compensation advisor provides other services to the issuer;
- the amount of fees received from the issuer by the entity employing the compensation advisor as a percentage of the total revenues

of the entity that employs the compensation advisor;

- the policies and procedures of the entity employing the compensation advisor that are designed to prevent conflicts of interest;
- any business or personal relationships between the compensation advisor and a member of the compensation committee; and
- any stock of the issuer owned by the compensation advisor.

Consistent with the proposed rules on the independence of compensation committee members, exchanges are free to select other factors that compensation committees are required to consider when determining independence of compensation advisors. In that regard, the proposed rules seek comments on two related issues: (i) while the Commission states its view that the factors described above are generally comprehensive, it asks whether there are additional independence factors that should be required to be taken into consideration by a compensation committee when selecting a compensation advisor, and (ii) it asks whether the five enumerated factors are "competitively neutral."

The Dodd-Frank Act does not require that a compensation advisor be independent, only that the compensation committee consider the enumerated independence factors before selecting a particular compensation advisor, and the

Commission expressly states in the proposing release that the listing standards should not establish materiality or bright-line numerical thresholds with respect to any factor. However, the Commission seeks comment on the application of the proposed independence factors in a number of enumerated circumstances.

With respect to the retention of independent legal counsel, the Commission states in the proposing release that the statute does not require that a listed company's compensation committee hire independent legal counsel. The Commission also expressly states that nothing in the Dodd-Frank Act or the proposed rules is intended to preclude a compensation committee from retaining non-independent legal counsel or obtaining advice from in-house counsel or outside counsel retained by the issuer or management.

Compensation Consultant Disclosure and Conflicts of Interest

Section 10C of the Exchange Act, as enacted in the Dodd-Frank Act, requires that in connection with an annual meeting at which directors are to be elected, an issuer must disclose whether the compensation committee has obtained the advice of a compensation consultant, whether the work of that compensation

consultant has raised any conflicts of interest and if so the nature of the conflict and how the conflict is being addressed.

Item 407(e)(3) of Regulation S-K currently requires an issuer to disclose "any role of the compensation consultants in determining or recommending the amount or form of executive and director compensation," including identifying the consultant, stating whether the consultant was engaged directly by the compensation committee or any other person, describing the nature and scope of the consultant's assignment, and the material elements of any instructions given to the consultant under the engagement, disclosing the fees paid to the 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 provide both and the fees for additional services exceeded \$120,000 during the fiscal year. Further, Item 407(e)(3) currently excludes from the disclosure requirement any role of compensation consultants that was limited to consulting on a broad-based plan that does not discriminate in scope, terms or operation in favor of executive officers or directors and is available generally to all salaried employees or limited to providing non-customized benchmark data.

Rather than overlay the new

requirements on the existing disclosure rules, the proposed rules integrate the existing disclosure requirements with the requirements of the Dodd-Frank Act to create a new disclosure rule. These new modified disclosure requirements will apply to all Exchange Act registrants, whether or not listed on a national securities exchange and whether or not they are a controlled company. With respect to the proposed disclosure requirement:

- the trigger for disclosure has been expanded from the existing standard, which is whether the consultant played "any role" in determining or recommending the amount or form of executive and director compensation, to whether the committee or management, as the case may be, "retained or obtained the advice" of a compensation consultant (the instructions to the new disclosure requirement clarify that the term "obtained the advice" relates broadly to whether the compensation committee or management has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant, a client relationship or any payment of fees to the consultant for its advice);
- the disclosure as to whether the consultant's work raised any conflict of interest (and if so, the

nature of the conflict and how it was addressed) will be required without regard to the existing exceptions to required disclosure;

- consistent with the existing disclosure rules, the new modified disclosure rules only require disclosure with respect to compensation consultants and not with respect to independent legal counsel or other advisors (although the Commission seeks comments as to whether this is appropriate);
- the proposed rules do not define the term “conflict of interest.” However, in light of the linkage between the requirement that compensation committees of listed issuers consider independence factors before retaining compensation advisors and the disclosure requirements regarding compensation consultant conflicts of interest, the instructions to the proposed disclosure rules identify the same independence factors described above as a non-exclusive list of factors to be considered in determining whether there is a conflict of interest requiring disclosure. Notwithstanding, the Commission in the proposing release expressly states: (i) that it has not concluded that the presence or absence of any of these individual factors indicates that a conflict of interest exists; and (ii) that the existence of fees that trigger disclosure

necessarily means that a conflict of interest is present;

- if the compensation committee determines that there is a conflict of interest with the compensation consultant based on the relevant factors and circumstances, the registrant will be obligated to provide a clear, concise and understandable description of the specific conflict and how the company addressed it (general descriptions of the registrant’s policies and procedures with respect to addressing conflicts of interest will not be enough); and
- the existing fee-disclosure requirements remain essentially the same, including the existing exception for services that are limited to consulting on broad-based plans and the provision of non-customized benchmark data.

The proposing release also seeks comments on a series of questions regarding the proposed disclosure rules, including whether smaller reporting companies should be exempted from these disclosure requirements.

Opportunity to Cure Defects

The proposed rules require that exchanges establish definitive procedures and compliance periods (if they do not already have such procedures and compliance periods in place) to be followed prior to delisting an issuer’s securities for failure to comply with these rules. Further, as required by the Dodd-Frank Act and

similar to the provisions that are in place for audit committee members under applicable Commission rules, the proposed rules include a safe harbor for any member of a compensation committee who ceases to be independent for reason outside such member’s reasonable control and allow such member to remain on the compensation committee until the earlier of the issuer’s next annual meeting or one year from the event that caused the member to no longer be independent.

Next Steps

It is unclear at this point whether these rules will be in effect for the 2012 proxy season. However, companies may wish to consider taking steps at this time to prepare for the adoption of these proposed rules, including reviewing compensation committee composition in anticipation that these proposed changes will be adopted and adopting advisor retention policies that will permit the compensation committee to assess up front, before consultants are retained, whether conflicts of interest may exist. Further, once the SEC’s rules are finalized and even before new listing standards are adopted, companies will become obligated, in connection with stockholder meetings at which directors will be elected, to make the required disclosures as to the retention of compensation consultants and conflicts of interest. Finally, once revised listing standards are adopted, compensation

committees will need to review and amend their committee charters to reflect the implementation of the new rules.

For further information or for help in assessing how the proposed rules may affect your company, please contact your principal lawyer at the firm or one of the lawyers listed below:

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