

## Executive Compensation Alert:

SEC Proposes New Rules for Compensation Committees and Compensation Consultants

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Fenwick  
FENWICK & WEST LLP

### SUMMARY

The SEC has proposed rules to implement Dodd-Frank Act Section 952, requiring national securities exchanges to prohibit the initial or continued listing of any stock of a company that does not satisfy Compensation Committee member independence criteria and Compensation Committee adviser independence criteria. It also proposed new disclosure requirements about use of compensation consultants and any related conflicts of interest. Given the time required for the stock exchanges to propose and adopt new listing standards, the principal impact of the Proposal should be felt in the 2012 proxy season.

The Proposal is available here: <http://www.sec.gov/rules/proposed/2011/33-9199.pdf>

### COMPENSATION COMMITTEE MEMBER INDEPENDENCE

#### *Consideration of Relevant Factors*

The Proposal would require national securities exchanges (e.g., NYSE and NASDAQ) to adopt listing criteria related to Compensation Committee member independence. The Compensation Committee must consist solely of members of the Board who are independent, and the definition of “independence” is to be established by the exchanges after taking into consideration “relevant factors” that the Dodd-Frank Act mandated, including:

- the source of the Board member’s compensation, including any consulting, advisory or other fees paid by the company; and
- whether a Board member is affiliated with the company or any subsidiary of the company.

The SEC did not propose any additional factors that must be considered by the exchanges in establishing these new listing criteria, but the exchanges have the discretion to consider other factors.

The SEC noted that NASDAQ listing standards (unlike NYSE) – allow executive compensation to be determined or recommended to the Board by either an independent committee or a majority of the Board’s independent directors. The Proposal would not require the new listing standards to apply to independent directors who oversee executive compensation in lieu of a Board committee.

#### *Comparison to Audit Committee Member Independence Criteria*

Unlike the Sarbanes-Oxley Act and Rule 10A-3, which prohibit certain persons from serving as Audit Committee members due to their relationship with the company, the Dodd-Frank Act and the Proposal are intended to provide the exchanges with flexibility in establishing Compensation Committee independence criteria. The Proposal does not contain any mandatory disqualifications from membership, and it does discuss and solicit comment on the possibility that significant investors (such as venture capital firms or private equity funds) may be well qualified to serve on Compensation Committees. Those directors are often well-positioned to exercise independent judgment regarding compensation due to their experience in the industry sector and can offer perspectives that are largely in line with shareholders.

The Proposal does follow Rule 10A-3 in providing for an opportunity to cure defects in Compensation Committee member independence. It requires the exchanges to establish procedures to allow a Compensation Committee member who ceases to be independent for reasons outside the member’s control to remain on the committee until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member no longer to be independent.

## COMPENSATION CONSULTANTS AND ADVISERS

The Proposal would also require the exchanges to adopt listing criteria related to compensation consultant or adviser independence.

### *Authority to Engage*

The exchanges' listing criteria must provide that the Compensation Committee may, in its discretion, retain or obtain the advice of compensation consultants, independent legal counsel and other advisers (collectively, "Compensation Advisers"), with the company responsible for their appropriate funding as determined by the Compensation Committee. The Compensation Committee must be directly responsible for the appointment, oversight and compensation of any such Compensation Advisers.

### *Independence of Compensation Advisers*

The Proposal does not require that Compensation Advisers be "independent," but would require the Compensation Committee to take into consideration at least the following independence factors:

- 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 employer's total revenue;
- The policies and procedures of the person that employs the Compensation Adviser that are designed to prevent conflicts of interests;
- Any business or personal relationship of the Compensation Adviser with any Compensation Committee member; and
- Any stock of the issuer owned by the Compensation Adviser.

The exchanges may also consider other independence factors in drafting these adviser independence listing criteria.

The SEC chose not to adopt specific materiality or numerical thresholds with respect to the adviser independence factors, but is seeking comment on whether other factors should be considered.

## DISCLOSURE AND CONFLICTS OF INTEREST

Finally, the Proposal deals with the Dodd-Frank Act requirement that issuers disclose in their annual meeting proxy statements:

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

It is noteworthy as an initial matter that this disclosure is only required with respect to consultants to the Compensation Committee, and not for legal counsel or other advisers to the Compensation Committee.

The Proposal would modify existing S-K Item 407(e) to require disclosure whenever the Compensation Committee retained or obtained advice of a compensation consultant during the last completed fiscal year, even without a formal engagement and regardless of whether any fees were paid to the compensation consultant. Under current rules, disclosure is only triggered when compensation consultants played "any role" in the process for determining executive officer or director compensation. Also, the Proposal would go beyond existing Item 407(e) requirements by mandating disclosure even if the consultant only provides advice on broad-based plans or non-customized benchmark data. Compensation consultant fee disclosures would continue to exclude fees paid for consulting on non-discriminatory, broad-based plans and non-customized information.

The Proposal does not define “conflicts of interest” and instead proposes to add an instruction to Item 407(e) directing issuers, when disclosing potential conflicts of interest, to consider the same five Compensation Adviser independence factors discussed above (plus any additional factors the exchanges may identify). The SEC solicits comments on whether a “conflict of interest” should include the mere appearance of a conflict or potential conflicts, and whether disclosure should be expanded to apply to Compensation Advisers other than consultants.

## **TIMELINE**

July 16, 2011 is the deadline for SEC adoption of rules mandating stock exchange listing criteria related to Compensation Committee member independence and Compensation Committee adviser independence (and the SEC expects to meet that deadline). Once final SEC rules are published, the exchanges will have 90 days to propose their new listing standards and one year to obtain final SEC approval of the new listing standards.

July 21, 2011 is the deadline for the SEC to adopt final rules for the modified Item 407(e) disclosures related to compensation consultants and conflicts of interest. Issuers would be required to comply with those new disclosure rules for all annual meeting proxy statements filed after those rules are adopted.

**For more information, you may contact any attorney in the Executive Compensation and Employee Benefits Group.**

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Scott P. Spector (650.335.7251–[sspector@fenwick.com](mailto:sspector@fenwick.com))

Shawn E. Lampron (650.335.7642–[slampron@fenwick.com](mailto:slampron@fenwick.com))

Blake W. Martell (650.335.7606–[bmartell@fenwick.com](mailto:bmartell@fenwick.com))

John E. Ludlum (650.335.7872–[jludlum@fenwick.com](mailto:jludlum@fenwick.com))

Horace Nash (650.335.7934–[hnash@fenwick.com](mailto:hnash@fenwick.com))

Gerald Audant (415.875.2362–[gaudant@fenwick.com](mailto:gaudant@fenwick.com))

Elizabeth A. Gartland (415.875.2361–[egartland@fenwick.com](mailto:egartland@fenwick.com))

Nicholas F. Frey (650.335.7882–[nfrey@fenwick.com](mailto:nfrey@fenwick.com))

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