

## Client Alert

# SEC Issues Proposed Rules on Independence of Compensation Committees and Their Advisers

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## EXEQUITY

Independent Board and  
Management Advisors

**Update:** On April 29, 2011, the SEC extended the comment period for the proposed rules regarding listing standards for compensation committees to **May 19, 2011**.

A copy of the SEC release providing for this extension can be found at <http://www.sec.gov/rules/proposed/2011/33-9203.pdf>.

On March 30, 2011, the Securities and Exchange Commission (the "SEC") issued proposed rules to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which added Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act").

Section 10C requires the SEC to issue final rules no later than July 16, 2011, which would direct the national securities exchanges and national securities associations to prohibit the listing of an equity security if the company is not in compliance with the provisions of Section 10C. There are four major components to Section 10C and the SEC's proposed implementing rules:

- **Independence of Compensation Committee Members**—Each member of the compensation committee of the board must be a member of the board of directors and must be independent. The national securities exchanges must consider the following two factors in developing a definition for independence:
  - The source of compensation of a board member, including any consulting, advisory, or other compensatory fee paid by the company to the board member; and
  - Whether the board member is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

- **Selection of Compensation Consultant, Legal Counsel, and Other Advisers**—The compensation committee may only select a compensation consultant, legal counsel, or other adviser (collectively, the “advisers”) after consideration of a minimum of five specified independence factors:
  - The provision of other services to the company by the person that employs the adviser (the “advisory firm”);
  - The amount of fees received from the company by the advisory firm as a percentage of the advisory firm’s total revenue;
  - The policies and procedures the advisory firm has in place to prevent conflicts of interest;
  - Any business or personal relationship of the adviser with a member of the compensation committee; and
  - Any stock of the issuer owned by the adviser.

The proposed rules do not address whether the selection of an adviser before the effective date of the final rules would require compensation committees to reevaluate the selection based on consideration of the specified independence factors.

- **Authority of Compensation Committee**—The compensation committee has the sole discretionary authority to retain or obtain the advice of an adviser, and is directly responsible for the appointment, compensation, and oversight of the adviser’s work.
- **Compensation Consultant Disclosure and Conflicts of Interest**—The compensation committee must disclose whether it retained or obtained the advice of a compensation consultant, and if the work of the compensation consultant raised any conflict of interest. If a conflict of interest is raised, the company must disclose the nature of the conflict and how the conflict is being addressed. If a conflict of interest is not raised, it is our understanding that the disclosure would need to state that no conflict is raised. The SEC acknowledged that a compensation committee may be unable or reluctant to definitively conclude whether a conflict of interest exists, and is requesting comment on whether the rules should also include the appearance of a conflict of interest in the interpretation of what constitutes a conflict of interest.

The SEC's proposed rules set forth a timeline for when the rules must be finalized and adopted. Unless the exchanges and the SEC move faster than what is required, **we may not have final rules until July 2012**, which means that the disclosure requirements would apply only to proxies filed after that date. The chart below depicts the proposed timeline for the implementation of final rules.

3/30/2011	5/19/2011	7/16/2011	10/14/2011	7/16/2012
SEC issues proposed rules on independence of compensation committees and their advisers	Comments due on proposed rules to the SEC	Deadline for SEC to issue final rules directing the exchanges to issue rules which would preclude listing if not in compliance	Proposed deadline for exchanges to issue proposed rules that comply with the SEC's final rules	<ul style="list-style-type: none"> <li>Proposed deadline for exchanges to have their final rules approved by the SEC</li> <li><b>For annual meetings occurring after the effective date of the SEC's rules</b>, company must comply with the compensation consultant disclosure requirement</li> </ul>

### **Exequity's Comments on the SEC's Proposed Rules**

Basically, the SEC's proposed rules add little to the statutory requirements set forth in Exchange Act 10C. In fact, the SEC's proposed rules essentially "punt" any substantive rulemaking to the exchanges. The SEC's proposed rules do not require that companies have a compensation committee, and although the NYSE has such a requirement, NASDAQ does not. While the rules would apply to any committee with oversight over executive compensation, the rules would not apply to companies that do not have a committee designated with such oversight. The SEC chose not to add any additional factors that the exchanges should consider in determining the definition of independence of compensation committee members. The compensation committee adviser independence factors are identical to those in Exchange Act 10C, and the SEC elected not to define some of the ambiguous language in the statute (for example, a definition for "other services" or what constitutes a "business or personal relationship"). The compensation consultant disclosure requirements are also identical to those in Exchange Act 10C; however, the SEC's proposed rules integrate those requirements into its current compensation consultant disclosure requirements under Item 407(e)(3) of Regulation S-K.

To accomplish the integration with the Item 407(e)(3) requirements, relatively minor changes were made to the 407(e)(3) requirements, including the following:

- All of the 407(e)(3) requirements will apply to all Exchange Act registrants (i.e., there will not be different requirements for issuers versus nonissuers and controlled companies);
- The selection factors set forth for consideration of whether an adviser is independent are among the factors that should be considered in determining whether a conflict of interest exists; and
- The exemptions outlined in 407(e)(3) regarding what is not considered an “executive compensation service” (i.e., consulting on broad-based, nondiscriminatory plans or providing noncustomized information or customized information where the compensation consultant did not develop or advise on the parameters) are continued for purposes of the current fee disclosure requirement but are removed for purposes of determining whether the work of the compensation consultant raises any conflict of interest.

The practical effect of this can best be illustrated by an example. Assume a compensation consulting firm’s only executive compensation services provided to its client consists of consulting on the design of a 401(k) plan, in which executive officers participate but is broad-based and nondiscriminatory, and in providing noncustomized data on executive compensation (e.g., providing standard pay study results that are not tailored to the company’s specific facts or executives). The consulting firm also provides administration services to the client, fees for which are greater than \$120,000. Because the compensation consulting is limited solely to the items specifically exempted (i.e., consulting on the 401(k) plan and providing noncustomized data), no fee disclosure is required. However, under the SEC’s proposed rules, the compensation committee must consider whether the provision of the 401(k) design services and noncustomized data raises a conflict of interest. The required disclosure must state whether providing these services raised a conflict of interest and, if so, disclosure of the nature of the conflict and how it is being addressed also would be required.

If the consultant provides other services over \$120,000 and **any** nonexempt executive compensation services, then disclosure of: (i) the aggregate fees paid for **all** executive compensation services (including fees related to exempt services) and (ii) the aggregate fees paid for all non-executive compensation services would be required. In other words, nondisclosure of fees is available if the exempted services are the **only** executive compensation services provided. Further, disclosure of whether management engaged or recommended the engagement of the consultant for non-executive compensation services is required along with whether the compensation committee or board approved of such services by the consultant.

The Appendix provides a summary, in chart form, of the requirements of Exchange Act Section 10C and the SEC’s proposed rules.



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## Appendix: Summary of Requirements of Exchange Act Section 10C and the SEC's Proposed Rules

Provision	Exchange Act 10C Statutory Requirements	SEC's Proposed Rules
<p><b>General Rule/Applicability</b></p> <p><i>Exchange Act §10C(a)(1), (a)(4), (f)(1), (f)(3), (g)</i></p>	<ul style="list-style-type: none"> <li>• 10C(a) states that companies listed on a national securities exchange or national securities association would have <b>equity securities</b> delisted if issuer does not comply with the compensation committee independence requirements of Section 10C; however, 10C(f)(1) states that delisting would apply to <b>any security</b> if the issuer is not in compliance with <b>all</b> the requirements of Section 10C.</li> <li>• Certain issuers are exempt from compensation committee independence requirements.</li> <li>• Rule <b>permits</b> the exchanges to exempt a particular relationship from the compensation committee independence requirements or to exempt any category of issuer from the requirements of 10C.</li> <li>• Controlled companies are exempt from <b>all</b> requirements of 10C.</li> </ul>	<ul style="list-style-type: none"> <li>• Proposed Rule 10C(a)(1) and (2) implements the delisting requirement.</li> <li>• SEC's proposed rules provide that <b>all</b> of the requirements of the proposed rules apply only to issuers with listed <b>equity</b> securities; thus, companies with only listed debt securities are not subject to Section 10C's or the proposed rules' requirements.</li> <li>• Securities futures products and traded option contracts issued or cleared by a clearing agency are exempt from the definition of an equity security.</li> <li>• Leaves exemption authority to the exchanges, subject to the SEC's approval.</li> </ul> <p><b>SEC Commentary</b></p> <ul style="list-style-type: none"> <li>• There are no national securities associations that currently list equity securities.</li> <li>• SEC notes that foreign private issuers are exempt from the compensation committee independence requirements but are <b>not</b> exempt from the provisions related to adviser independence (however, foreign private issuers are not subject to the proxy rules and thus would not be subject to the disclosure requirements).</li> <li>• "Compensation committee" not defined; however, the requirements apply to any committee that has oversight for executive compensation, even if the committee is not designated as the compensation committee or performs other functions.</li> <li>• NYSE requires issuers to have a compensation committee; however, NASDAQ does not, and the SEC's proposed rules neither require the establishment of a compensation committee nor apply to companies that have the independent directors of the board (in lieu of a committee) oversee executive compensation.</li> </ul>

Provision	Exchange Act 10C Statutory Requirements	SEC's Proposed Rules
<p><b>Opportunity to Cure Defects</b></p> <p><i>Exchange Act §10C(f)(2)</i></p>	<ul style="list-style-type: none"> <li>The SEC will provide for procedures for a company to have an opportunity to cure any defects before a delisting is imposed.</li> </ul>	<ul style="list-style-type: none"> <li>Proposed Rule 10C-1(a)(3) would provide that exchanges may provide that if a member of the compensation committee ceases to be independent for reasons outside of his control, that person can remain on the compensation committee until the earlier of the next annual meeting or one year from the event that caused the member to no longer be independent.</li> </ul> <p><b>SEC Commentary</b></p> <ul style="list-style-type: none"> <li>SEC believes exchanges' current procedures to cure defects would satisfy the requirement to provide an opportunity to cure defects.</li> </ul>
<p><b>Independence of Compensation Committee Members</b></p> <p><i>Exchange Act §10C(a)(2) and (a)(3)</i></p>	<ul style="list-style-type: none"> <li>Each member of the compensation committee must be a member of the board of directors and be independent.</li> <li>In determining the definition of independence, the national securities exchanges must consider relevant factors, including:               <ul style="list-style-type: none"> <li>— The source of compensation of a member of the board, including any consulting, advisory, or other compensatory fees paid; and</li> <li>— Whether a member of the board is affiliated with the issuer, a subsidiary, or an affiliate of a subsidiary.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>The SEC's proposed rules do not specify any additional factors that the exchanges must consider in determining independence (Proposed Rule 10C-1(b)(1)).</li> <li>"Affiliate" not defined.</li> <li>Difference from audit committee requirements is that the exchanges have more discretion to determine the independence standards for compensation committee members than for audit committee members. The Exchange Act prescribes certain minimum independence criteria for audit committee members and states that certain relationships <b>preclude</b> independence. With respect to compensation committee members, these relationships must only be considered (and do not necessarily preclude independence).</li> </ul>

Provision	Exchange Act 10C Statutory Requirements	SEC's Proposed Rules
<p><b>Selection of Compensation Committee Advisers— Independence Factors</b></p> <p><i>Exchange Act §10C(b)</i></p>	<ul style="list-style-type: none"> <li>• Adviser can only be selected after consideration of independence factors identified by the SEC, which must be competitively neutral among categories of advisers and preserve the ability of the compensation committee to retain members from any category. This consideration must include, at a minimum, the following factors: <ul style="list-style-type: none"> <li>— Other services provided to the company by the <b>advisory firm</b>;</li> <li>— Fees received from the company by the <b>advisory firm</b> as a percentage of the advisory firm's total revenue;</li> <li>— Policies and procedures of the <b>advisory firm</b> that are designed to prevent a conflict of interest;</li> <li>— Any business or personal relationship of the <b>adviser</b> with a member of the compensation committee; and</li> <li>— Any stock of the company owned by the <b>adviser</b>.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Repeats statutory requirements (Proposed Rule 10C-1(b)(4)).</li> </ul> <p><b>SEC Commentary</b></p> <ul style="list-style-type: none"> <li>• Listing standards developed by the exchanges <b>must not</b> include any materiality, bright-line thresholds, or cut-offs (e.g., listing standards cannot implement a requirement that the compensation committee must consider a factor <b>only</b> if the materiality threshold is exceeded); however, the SEC is requesting comment on whether its rules should provide for materiality thresholds.</li> <li>• Exchanges can add other independence factors.</li> <li>• SEC did not address what constitutes a “business” or “personal relationship,” although comment is sought on whether it should.</li> <li>• “Other services” is not defined, although comment is sought on whether it should be defined.</li> <li>• SEC is seeking comment on whether it should require the compensation committee to disclose its process for selecting advisers.</li> </ul>
<p><b>Authority of Compensation Committee</b></p> <p><i>Exchange Act §10C(c), (d), (e)</i></p>	<ul style="list-style-type: none"> <li>• Compensation committee has sole discretion to retain or obtain the advice of advisers (compensation consultant, legal, and other advisers).</li> <li>• Compensation committee must be directly responsible for appointment, compensation, and oversight of adviser's work.</li> <li>• Compensation committee not required to implement or act consistently with adviser's advice.</li> <li>• Does not impact the ability of the compensation committee to exercise its own judgment.</li> <li>• Listed companies must provide appropriate funding for payment of reasonable compensation to the adviser.</li> </ul>	<ul style="list-style-type: none"> <li>• Repeats statutory requirements (Proposed Rules 10C(1)(b)(2) and (3)).</li> </ul> <p><b>SEC Commentary</b></p> <ul style="list-style-type: none"> <li>• Companies are not required to hire independent advisers.</li> <li>• Compensation committees are not precluded from using nonindependent or in-house advisers.</li> </ul>

Provision	Exchange Act 10C Statutory Requirements	SEC's Proposed Rules
<p><b>Compensation Consultant Disclosure and Conflicts of Interest</b></p> <p><i>Exchange Act §10C(c)(2)</i></p>	<ul style="list-style-type: none"> <li>• In any proxy for <b>an annual meeting</b> (or special meeting in lieu of an annual meeting), company must disclose:               <ul style="list-style-type: none"> <li>— Whether the <b>compensation committee retained or obtained</b> the advice of a compensation consultant; and</li> <li>— Whether the work of the compensation consultant raised <b>any</b> conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Proposed rules integrate the 10C(c)(2) requirements into the current disclosure requirements in Item 407(e)(3) of Regulation S-K.</li> <li>• Item 407(e)(3) currently requires disclosure in the <b>proxy for an annual meeting at which directors are elected, any role of compensation consultants</b> in determining or recommending executive and director compensation, including:               <ul style="list-style-type: none"> <li>— Identifying the consultants;</li> <li>— Stating whether the consultants are engaged directly by the compensation committee or any other person;</li> <li>— Describing the nature and scope of the consultants' assignment, and material elements of any instructions given to the consultants;</li> <li>— Disclosing the aggregate fees paid to the consultant for advice on executive compensation services and the aggregate fees for additional services if the consultant provides both, and the fees for the additional services exceed \$120,000; and</li> <li>— Consulting on nondiscriminatory, broad-based plans or providing noncustomized information or information that is customized based on parameters that are not developed by the compensation consultant and about which the compensation consultant does not provide advice are exempt from being considered executive compensation services.</li> </ul> </li> <li>• Integration would result in revising current Item 407(e)(3):               <ul style="list-style-type: none"> <li>— Keeping the current Item 407(e)(3) requirement which only requires disclosure in a proxy for an annual meeting at which directors are elected;</li> <li>— Applying requirements to <b>all</b> Exchange Act registrants, not just listed issuers;</li> <li>— Replacing the language of "any role" with whether the compensation committee "retained or obtained" the advice of a compensation consultant (not intended to be a substantive change);</li> </ul> </li> </ul>

Provision	Exchange Act 10C Statutory Requirements	SEC's Proposed Rules
		<ul style="list-style-type: none"><li>— Exemptions from executive compensation services are removed with respect to the <b>new</b> disclosure requirements (<b>however, exemptions are still in place with respect to the disclosure of fees</b>);</li><li>— “Obtained the advice” means that a compensation committee or management has requested or received advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant or a client relationship between the compensation consultant and the compensation committee or management or any payment of fees to the consultant for its advice;</li><li>— “Conflict of interest” not defined; however, instruction provides that the factors that are set forth in Section 10C for consideration before selecting a compensation consultant would be among the factors that should be considered in determining whether there is a conflict of interest that may need to be disclosed; and</li><li>— SEC is seeking comment on whether fee disclosure should be required (in percentage terms) if the advisory firm’s fees received from the company are more than 10% of the advisory firm’s annual revenues.</li></ul>