

## Public Company Alert



## SEC Proposes New Compensation Committee Rules

On March 30, 2011, the SEC proposed new compensation committee rules for public companies. The rules would implement section 952 of the Dodd-Frank Act, which requires the SEC to issue rules regarding compensation committee independence.

The proposed rules contain two components: directing stock exchanges to prohibit the listing of any equity security of a company that fails to meet new compensation committee independence standards, and revising the compensation consultant disclosure required in proxy statements under Regulation S-K Item 407.

The wording of the SEC's proposed rules closely tracks the wording of the applicable Dodd-Frank Act provision. As has not been the case with several other recent proposals, the SEC Commissioners supported the proposed rules unanimously.

A brief summary of the proposed rules is below, followed by an addendum setting forth Regulation S-K 407(e)(3)(iii) marked to show the SEC's proposed changes.

### Stock Exchange Listing Requirements

Proposed Rule 10C-1 would direct the national securities exchanges (including the NYSE, the NASDAQ Stock Market, NYSE Amex, NYSE Arca, NASDAQ OMX BX and the Chicago Stock Exchange) to prohibit the listing of any equity security of a company that fails to meet new compensation committee independence standards. Under these standards:

- Each member of the compensation committee must be an "independent" director. The definition of "independence" is left to the exchanges to decide by official rulemaking. In conducting this rulemaking, however, the exchange must consider the source of director compensation and whether the director is affiliated with the company or its subsidiaries.
- The compensation committee must have the power, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser. The compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any such adviser.
- Companies must provide appropriate funding for the compensation committee to pay its advisers.

The proposed rules would require that the compensation committee only select a compensation consultant, legal counsel or other adviser after taking into consideration the following independence factors, as well as any additional factors added by the exchanges in their rulemakings:

- the provision of other services to the company by the person that employs the adviser;

- the amount of fees received from the company by the person that employs the adviser, as a percentage of the total revenue of the person that employs the adviser;
- the policies and procedures of the person that employs the adviser that are designed 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 company owned by the adviser.

The proposed rules, however, would not require the compensation committee to hire any outside compensation consultant, legal counsel or other adviser, or require that such advisers in fact be independent. Compensation committees may continue to consult in-house counsel and advisers or counsel retained by management, if they so choose. Nothing in the proposed rules would require the compensation committee to follow the advice provided by an adviser.

The new listing standards would apply to any committee of the board that performs functions typically performed by a compensation committee, even if the committee has a different name. The SEC's proposing release, however, makes it clear that the new rules would not apply to companies that do not have any committee performing compensation functions. Nothing in the rules would require companies to establish or maintain a compensation committee.

The proposed rules would direct the exchanges to allow companies an opportunity to cure a failure to comply with the rules prior to being delisted.

The new rules would not apply to debt-only listings, and the rules would exempt certain companies, including controlled companies and certain foreign private issuers. Unlisted companies, including companies that only trade through the OTC Bulletin Board or the OTC Markets Group, would not be subject to the rules.

Once Rule 10C-1 is finalized and published in the Federal Register, the exchanges would have 90 days to propose their listing rules. The exchanges would then need to get the new listing rules approved by the SEC no later than one year after publication of Rule 10C-1 in the Federal Register.

### **Proxy Disclosure Requirements**

The SEC's proposed rules would also amend Regulation S-K Item 407(e)(3)(iii), which requires proxy statement disclosure about compensation committee consultants. The proposed rule would conform Item 407(e)(3)(iii) to the language specified by section 952 of the Dodd-Frank Act. This revised disclosure item would apply to all companies subject to the SEC's proxy rules, including any unlisted companies or controlled companies subject to the proxy rules. In the SEC's view, the practical effect of the amendment would be minimal.

The addendum below sets forth Regulation S-K 407(e)(3)(iii) marked to show the SEC's proposed changes. Pursuant to these changes, companies would disclose:

- whether the compensation committee "retained or obtained" the advice of a compensation consultant (the old language referred to disclosure regarding "any role" of compensation consultants); and
- whether the work of the consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Much of the remainder of Item 407(e)(3) would remain unchanged. Companies would still be required to disclose information about the nature of the consultant's work and, in certain circumstances, information about additional services provided to the company by the compensation consultant.

The amendment would add two new instructions to Item 407(e)(3):

- the compensation committee or management will be deemed to have "obtained the advice" of a compensation consultant if the compensation committee or management has requested or received advice from the consultant, regardless of whether there is a formal engagement or formal fee payment; and
- the independence factors set forth in new Rule 10C-1 (described above) are among the factors that should be considered in determining whether a conflict of interest exists.

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**Addendum:**  
**Regulation S-K Item 407(e)(3)(iii) Marked to Show Proposed SEC Changes**

(Item 407) Corporate governance

\* \* \* \*

(e) \* \* \*

(3) \* \* \*

(iii) ~~Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation (other than any role limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) during the registrant's last completed fiscal year, identifying such consultants, stating whether such consultants were engaged directly by the compensation committee (or persons another board committee performing the equivalent functions) or any other person, describing the nature and scope of their the consultant's assignment, and the material elements of the instructions or directions given to the consultants consultant with respect to the performance of their the consultant's duties under the engagement, and discussing whether the work of the consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed:~~ Whether the compensation committee (or another board committee performing equivalent functions) retained or obtained the advice of a compensation consultant during the registrant's last completed fiscal year, identifying such consultants, stating whether such consultants were engaged directly by the compensation committee (or persons another board committee performing the equivalent functions) or any other person, describing the nature and scope of the consultant's assignment, and the material elements of the instructions or directions given to the consultant with respect to the performance of the consultant's duties under the engagement, and discussing whether the work of the consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed:

(A) If ~~such compensation consultant was engaged by~~ the compensation committee (or ~~persons another board committee performing the equivalent functions) to provide~~ retained or obtained the advice ~~or recommendations on the amount or form of executive and director of a compensation (other than any role consultant and the consultant's services were not~~ of a compensation ~~(other than any role consultant and the consultant's services were not~~ of a compensation (other than any role consultant and the consultant's services were not limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice), and the compensation consultant or its affiliates also provided additional services to the registrant or its affiliates in an amount in excess of \$120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for such additional services. Disclose whether the

decision to engage the compensation consultant or its affiliates for these other services was made, or recommended, by management, and whether the compensation committee (or another board committee performing equivalent functions) or the board approved such other services of the compensation consultant or its affiliates.

(B) If the compensation committee (or ~~persons~~another board committee performing ~~the~~ equivalent functions) has not ~~engaged~~retained or obtained the advice of a compensation consultant, but management has ~~engaged~~retained or obtained the advice of a compensation consultant ~~to provide advice or recommendations on the amount or form of executive and director compensation (other than any role and the consultant's services were not~~ limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; ~~or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice~~, and such compensation consultant or its affiliates has provided additional services to the registrant in an amount in excess of \$120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the compensation consultant or its affiliates.

Instruction 1 to Item 407(e)(3). For purposes of this paragraph, a compensation committee (or another board committee performing equivalent functions) or management has "obtained the advice" of a compensation consultant if such 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.

Instruction 2 to Item 407(e)(3). For purposes of this paragraph, the factors outlined in §240.10C-1(b)(4)(i) through (v) of this chapter are among the factors that should be considered in determining whether a conflict of interest exists.

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