

# Meridian Client Update

April 6, 2011

## SEC Proposes Stricter Rules Regarding Independence of Compensation Committees and Compensation Consultants

On March 30, 2011, the SEC proposed rules directing the national securities exchanges to adopt certain listing standards related to the compensation committee of a company's board of directors, and modifying current rules on compensation consultant conflicts of interest disclosure. The proposed rules and rule amendments implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which adds Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act") Under the Dodd-Frank Act, the SEC is directed to require national securities exchanges and national securities associations to **prohibit** the listing of any equity security of a company (subject to certain limited exceptions) that does not comply with the compensation committee and compensation adviser requirements to be promulgated by the SEC.

Pursuant to the SEC's rulemaking schedule implementing Dodd-Frank Act provisions, final rules on compensation committee independence and compensation consultant conflicts of interest disclosure are expected to be issued between April and July 2011.

### Highlights of the Proposed Rules

- The proposed rules largely mirror the compensation committee standards set forth in the Dodd-Frank Act.
- Securities exchanges would be required to adopt listing standards that require each member of a company's compensation committee to be "independent". The securities exchanges would have flexibility in developing a definition of independence applicable to their members.
- Securities exchanges would be required to adopt rules granting compensation committees the authority to retain compensation advisers.
- Compensation committees would be required to consider specific independence factors before selecting a compensation adviser.
- The proposed rules modify existing proxy disclosure rules regarding compensation consultant conflicts of interest to require disclosure under broader circumstances, and include an instruction on what factors to consider in determining whether disclosure is required.

## Independence of Compensation Committee Members

Under the SEC's proposed rules, securities exchanges would be required to adopt listing standards that require each member of the company's compensation committee to be "independent". As required by Section 10C(a)(1) of the Exchange Act, the SEC's proposed rule would direct securities exchanges to develop a definition of independence applicable to their members, taking into account relevant factors, including:

- The source of compensation of a member of the board of directors, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors; and;
- Whether a member of the board of directors of a company is affiliated with the company, subsidiary of the company or an affiliate of a subsidiary of the company.

The SEC's proposed rules are consistent with the mandates of Section 10C(a) of the Exchange Act and do not specify any additional factors that the exchanges must consider in determining the independence requirements for members of compensation committees. Rather, the SEC's proposed rules provide securities exchanges flexibility to establish their own minimum independence criteria as each exchange deems appropriate, subject to SEC approval.

- **Opportunity to Cure Violations of Compensation Committee Independence Standards.** The SEC's proposed rules provide that securities exchanges' rules may provide that if a member of the compensation committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member of the company until the earlier of the company's next annual meeting or one year from the occurrence of the event that caused the member to no longer be independent.
- **Applicability of Listing Requirements.** Although the term "compensation committee" is used, the proposed rules would be applicable to **any committee** of the board that oversees executive compensation whether or not the committee performs multiple functions and/or is formally designated as a "compensation committee."
- **Exemption from Compensation Committee Standards.** As directed by the Dodd-Frank Act, the proposed rules provide that securities exchanges must exempt the following five categories of companies from the compensation committee independence requirements:
  - Controlled companies;
  - Limited partnerships;
  - Companies in bankruptcy proceedings;
  - Open-end management investment companies registered under the Investment Company Act of 1940; and
  - Any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee.

In addition, the SEC's proposed rules authorize securities exchanges to exempt a category of companies from the compensation committee standards, as they determine appropriate. In making such determination, the national securities exchange or the national securities association must take into account the potential impact of the requirements on smaller reporting companies.

- **Comparison to Independence Standards for Audit Committees under Sarbanes-Oxley Act.** In proposing the new rules, the SEC considered the similarities and differences between Section 952 of the Dodd-Frank Act and Section 301 of the Sarbanes-Oxley Act of 2002. Section 301 of the Sarbanes-Oxley Act of 2002 added Section 10A(m)(1) to the Exchange Act, which required the Commission to prescribe independence standards for audit committee members. Although the independence factors in Section (C)(a)(1) of the Exchange Act are similar to those in Section 10A(m)(1), there is **one significant difference**. Section (C)(a)(1) requires only that the exchanges “**consider** relevant factors” (emphasis added) in developing independence standards for compensation committee members, whereas in Section 10A(m)(1) expressly states that certain relationships preclude independence with respect to audit committee members.

### **Authority of the Compensation Committee to Retain a Compensation Adviser**

The SEC’s proposed rules would require securities exchanges to adopt listing standards that grant the compensation committee of listed companies the authority to retain or obtain the advice of a compensation adviser and to oversee the compensation adviser and payment of the compensation adviser’s fees. The proposed rules further require that a compensation adviser’s fees must be appropriately funded by a listed company.

Under NYSE governance standards, compensation committees of listed companies already have the right to retain and oversee compensation advisers.

### **Selection of Independent Adviser**

The proposed rules also require securities exchanges to adopt listing standards providing that the compensation committee may **only** select a compensation consultant, legal counsel or other adviser (“Adviser”) after taking into account the following five independence factors:

- The rendering of “other services” to the company by the Adviser.
- The amount of fees received from the company by the Adviser, as a percentage of the Adviser’s total revenue.
- The policies and procedures of 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.
- Any stock of the company owned by the Adviser.

Meridian Compensation Partners was specifically designed to prevent potential conflicts of interest. As such, Meridian consultants can assure their Compensation Committee clients they will clearly meet these new standards.

In accordance with Section 10C(b) of the Exchange Act, the SEC is directed to issue rules setting forth independence factors which are to be “competitively neutral”. Notably, neither the statute nor the proposed SEC rules require an Adviser to be independent; rather, the proposed SEC rules only require a compensation committee to consider the enumerated independence factors before selecting an Adviser.

### Compensation Consultant Conflict of Interest Disclosure

Item 407 of Regulation S-K currently requires companies subject to the Exchange Act's proxy rules to provide certain disclosures concerning their compensation committees and the use of compensation consultants. Under the current disclosure rules, a company is generally required to disclose "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation", including:

- The identity of the consultants;
- Whether such consultants were engaged directly by the compensation committee or any other person;
- A description of the nature and scope of the consultants' assignment, and the material elements of any instructions given to the consultants under the engagement; and
- The aggregate fees paid to a consultant for advice or recommendation on the amount or form of executive and director compensation and the aggregate fees for additional services **if** the consultant provided both **and the fees for additional services exceeded \$120,000 during the fiscal year**.

The SEC's proposed rules amend the disclosure require by Item 407 of Regulation S-K for companies subject to the proxy rules to integrate new disclosure requirements of Section 10(c)(2) with the existing disclosure rules. Specifically, the proposed rules would modify existing rules to require disclosure about whether:

- The compensation committee has retained or obtained the advice of a compensation consultant during the company's last completed fiscal year; and
- The work of the compensation consultant has raised any conflict of interest, and, if so, the nature of the conflict and how the conflict is being addressed.

The SEC proposes to include an instruction that identifies the five factors set forth in the proposed rule on the selection of an independent adviser, as described above, as among the factors to be considered in determining whether there is a conflict of interest that may need to be disclosed.

The proposed rules would eliminate the current disclosure exception for services that are limited to consulting on broad-based plans or provides only non-customized benchmarking data. In this regard, the proposed rules would **broaden** the scope of disclosure currently required by Item 407 of Regulation S-K.

The new disclosure requirements of Section 10(c)(2) would be disclosed in proxy statements only for annual meetings at which directors are to be elected.

**Meridian Commentary:** The proposed rules on compensation committees and compensation consultants are primarily mirroring the provisions of Section 952 of the Dodd-Frank Act. We have seen many public companies already rigorously evaluating the independence factors set forth in the proposed rules. In light of the focus on compensation consultant conflicts of interest, we believe the broad movement by compensation committees to retain independent consultants that are not part of larger multi-service line firms will continue, if not escalate.

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