

Client Alert

April 19, 2011

SEC Proposes Rules for Implementing New Compensation Committee and Consultant Independence Standards

New Disclosure Standards Effective for Proxies Filed in 2011

Executive Summary

On March 30, 2011, the SEC issued Proposed Rules to implement the Dodd-Frank Act provisions related to Compensation Committee member and advisor independence, Committee authority, and related disclosure rules. Most of the rule-making authority has been delegated to the national stock Exchanges and will take the form of additional listing standards. As a result, PM&P believes that companies generally do not need to take action at this time, but should await rules issued by the Exchanges.

Overview and Timing

The SEC has issued Proposed Rules to implement new Compensation Committee standards under the Dodd-Frank Act relating to:

- Member Independence
- Hiring Authority and Funding for Advisors
- Advisor Independence
- Disclosure of Advisor Use and Potential Conflicts of Interest

For the first three issues above, the SEC generally adopted the statutory language used in Section 952 of Dodd-Frank, provided little additional guidance, and then deferred to the NYSE and Nasdaq to develop their own detailed rules around Committee independence and authority after the Final Rules are issued. As a result, for these three issues, the issuance of the SEC's Proposed Rules represents the starting point for a process likely to proceed as follows:

- SEC issues Proposed Rules (March 30, 2011)
- SEC comment period (March 30, 2011 – April 29, 2011)
- SEC issues Final Rules directing Exchanges to act (by July 16, 2011)
- Exchanges issue Proposed Rules (within 90 days of SEC Final Rules)

- SEC approves Exchange Proposed Rules
- Exchange Final Rules Issued (within one year of SEC Final Rules, or by July, 2012)

Practically speaking, Final Rules for these issues will not likely take effect until July, 2012. However, the impact of Section 952 will not be clear until the Exchanges' Proposed Rules are released. In addition, companies will have a grace period to address any independence issues until the earlier of the next annual meeting or one year from the event that triggered the independence issue.

PM&P Observation: Because the SEC's Proposed Rules provide little additional insight, we anticipate most companies will await guidance from the Exchanges before taking any action.

The SEC's process with regard to the Disclosure of Advisor Use and Potential Conflicts of Interest rule is more straightforward and does not rely on the Exchanges' rule-making authority. As such the SEC is expecting to issue Final Rules in July, 2011 (after a comment period ending April 29, 2011) with applicability to proxy statements filed after that date.

PM&P Observation: Companies may want to revisit their disclosures with regard to advisors and conflicts in the near future as it is likely to be applicable for proxies filed after July, 2011.

This Client Alert discusses Section 952 in detail and highlights where the Proposed Rules provide further guidance or defer to the Exchanges for additional rulemaking. An updated timeline for implementation of the various compensation-related provisions under Dodd-Frank is provided at the end of this Alert.

Compensation Committee Member Independence

Section 952 requires Compensation Committee members to meet independent standards determined by the Exchanges, which also are authorized to prohibit the listing of any company not meeting their standards. In determining member independence, Dodd-Frank directs the Exchanges to consider:

- The sources of any additional compensation paid to Committee members by the company (including consulting, advisory or other fees); and
- Whether any Committee members are affiliated with the Company, its subsidiaries or affiliates.

The only clarifying guidance provided by the SEC was to emphasize that these two factors are for the Exchanges' **consideration** and are **not** bright line prohibitions, as they are for Audit Committee members. The Proposed Rules also defer to the Exchanges to decide if significant stock ownership should be considered when determining member affiliation. Accordingly, we do not know the impact, if any, on the independence status of directors who are representatives of private equity firms until the Exchange listing standards are finalized.

The Proposed Rules clarify that Section 952 does not require companies to maintain a Compensation Committee, unless otherwise required by their Exchange. Currently, NYSE companies must maintain a Compensation Committee, but Nasdaq does not require companies to do so (although Nasdaq does require executive compensation decisions by its listed companies be approved either by a Compensation Committee or a majority of the Board's independent directors).

Dodd-Frank exempts the following categories of registered companies from its Compensation Committee independence rules:

- Controlled companies (i.e., companies owned 50% or more by a single investor or group of investors)
- Limited partnerships
- Companies in bankruptcy proceedings
- Open-end management investment companies registered under the Investment Company Act of 1940
- Any foreign private issuer that discloses in its annual report why it does not have an independent Compensation Committee
- Companies traded on the OTC Bulletin Board and OTC Markets Group
- Any further exemptions deemed appropriate by the Exchanges based on company size or other factors

Compensation Committee Authority and Funding

The Proposed Rules essentially track the language of Dodd-Frank, which allows Compensation Committees “sole discretion” to retain, pay and oversee their compensation consultants, legal counsel and other advisers. Companies also must provide appropriate funding for those advisers, as determined by the Compensation Committee. Finally, Committees are not required to accept or act on any recommendations made by their outside advisers.

Compensation Committee Advisor Independence

Dodd-Frank does not require that compensation consultants, legal counsel and other advisers to the Compensation Committee be independent. However, the Act did direct the SEC to identify factors to be considered in an independence assessment, including:

- Other services provided by the advisor’s firm to the company;
- Fees received by the advisor’s firm from a company as a percentage of the total revenue of the advisor’s firm;
- Policies or procedures maintained by the advisor’s firm designed to prevent a conflict of interest;
- Any business or personal relationship between the adviser and a Compensation Committee member; and
- Any company stock owned by the advisor.

The Act clarifies that in considering these factors, the SEC should be competitively neutral among different categories of consultants, counsel and other advisers.

PM&P Observation: The Proposed Rules adopt these five factors and provide no other guidance, declining to offer bright line tests or numerical thresholds. However, the SEC emphasized the Exchanges can develop additional independence factors. We will be tracking these developments as further guidance becomes available.

Disclosure of Advisors and Conflicts of Interest

The Proposed Rules would eliminate some current exemptions to disclosure of Compensation Committee advisors, but otherwise are similar to existing SEC requirements that are intended to avoid conflict of interest and independence issues.

Effective for proxies related to meetings occurring on or after July 21, 2011, Dodd-Frank requires that companies disclose:

- Whether the Compensation Committee retained or obtained advice from a compensation consultant; and
- Whether such work raised a conflict of interest and, if so, the nature of the conflict and how it was addressed.

Current rules already require listed companies to disclose: (i) the consulting firm's identity; (ii) whether the consulting firm was engaged directly by the Committee or by another person; and (iii) the nature and scope of the consulting firm's assignment and the material instructions given to the firm. Under current rules, companies are exempted from this disclosure if the only services provided by the advisor are either:

- Advice on a broad-based plan that did not discriminate in scope, terms or operation in favor of executive officers or Directors of the company (broad-based consulting); or
- Information not customized or customized based on parameters not developed by the consultant and about which the consultant did not advise (non-customized benchmark data).

The Proposed Rules would eliminate these exemptions. The identity, nature of the engagement, scope of assignment and instructions, and whether the work raised any conflicts would need to be disclosed and discussed even if the consultant provides only advice on broad-based plans or non-customized benchmark data.

Current rules also require companies to disclose fees paid for executive/Director consultant services **and** fees paid for other services rendered by the same consultant if the fees for the other services exceed \$120,000 for the fiscal year. In determining the threshold for this fee disclosure, the broad-based consulting and non-customized benchmark data exemptions still apply.

Additionally, the Proposed Rules would broaden existing standards by clarifying that consultant disclosure is triggered **whenever** a Committee retains or obtains the advice of a consultant, regardless of:

- Whether there is a formal engagement;
- The fees paid; or
- Whether the consultant actually played a role in determining or recommending the amount or form of executive and Director compensation.

The Proposed Rules also broaden the consultant disclosure section by requiring a discussion of conflicts of interest. The SEC declined to further define "conflict of interest," but indicated that the five factors used to assess consultant independence would be relevant, along with a general facts and circumstances assessment of the relationship. If a Committee identifies a conflict, the proxy must contain a clear, concise and understandable explanation of the specific conflict and how the company has addressed it. Providing a general description of the company's policies and procedures to address conflicts or the appearance of conflicts is not sufficient.

Finally, in the interest of developing one set of uniform reporting rules, the new disclosure rules would apply to all reporting companies, even controlled companies and foreign private issuers that are not currently subject to Committee independence standards.

Conclusion and Updated Implementation Schedule

Other than providing further guidance on advisor disclosure, the Proposed Rules generally do not provide enough information to warrant an immediate response by companies. We will be tracking future developments and advising as further guidance is provided by the Exchanges.

Below is our evolving chart tracking rulemaking and likely implementation dates of compensation related Dodd-Frank provisions. As discussed above, it is possible that rules governing Committee and consultant independence could be delayed past the 2012 proxy season, depending on how quickly the SEC and Exchanges adopt final rules. Proposed and final guidance for disclosure of pay-for-performance, the ratio of CEO pay to other employees, hedging and clawbacks is now expected to be released between August and December of 2011, so these provisions are likely to be effective for the 2012 proxy season.

Provision	Effective Dates in DFA	Current Known Status or Scheduled Action
Say on Pay and Say on Frequency	Proxy statements for meetings on or after 1/21/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Say on Golden Parachute	Effective on or after 4/25/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Financial Institution Excessive Compensation Rules	Rules to be issued by 4/21/2011	Proposed Rules Issued by Joint Regulators Feb & Mar., 2011 Final Rules scheduled for Aug. – Dec., 2011 Likely effective for 2012 proxy season
Compensation Committee & Advisor Independence; Committee's Oversight Authority	Effective by 7/16/2011	SEC issued Proposed Rules Mar. 30, 2011 Exchanges to issue Proposed Rules by Oct., 2011 Approved by SEC and effective no later than July, 2012
Disclosure of Compensation Consultant Conflict of Interest	Proxy statements for meetings occurring on or after 7/21/2011	SEC issued Proposed Rules Mar. 30, 2011 SEC to issue Final Rules by July, 2011 Likely to be effective as of July, 2011
Clawback Policy	None stated	SEC to issue Proposed & Final Rules Aug.– Dec., 2011 Likely effective for 2012 proxy season
Pay-for-Performance Disclosure	None stated	SEC to issue Proposed & Final Rules Aug.– Dec., 2011 Likely effective for 2012 proxy season
Internal Equity Ratio Disclosure	None stated	SEC to issue Proposed & Final Rules Aug.– Dec., 2011 Likely effective for 2012 proxy season
Disclosure of Hedging	None stated	SEC to issue Proposed & Final Rules Aug.– Dec., 2011 Likely effective for 2012 proxy season
Disclosure of COB/CEO Roles	None stated, but it is so similar to 2010 rule that most companies have complied in the 2011 proxy	SEC did not commit to dates for guidance; Most companies discussed in 2011 proxies
Proxy Access	SEC issued final proxy rules August 25, 2010; effective 60- days from publication in Federal Register, but delayed implementation pending Court of Appeals review	Court of Appeals review – expedited, but no firm dates set
Broker Non-Vote on Executive Compensation	Effective 7/21/10	SEC to issue clarifying Final Rules TBD; but effective for 2011 proxy season

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