

# LEGAL UPDATE

April 2011 *By: Michael T. Campoli*

## **SEC PROPOSES RULES REGARDING THE INDEPENDENCE OF COMPENSATION COMMITTEE MEMBERS AND ADVISERS, AND RELATED DISCLOSURE REQUIREMENTS**

On March 30, 2011, the U.S. Securities and Exchange Commission (the “SEC”) proposed new rules to implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Section 952 added a new Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”), which requires the SEC to adopt rules directing the national securities exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with the compensation committee independence and compensation adviser requirements of the Dodd-Frank Act.

The proposed rules require the national securities exchanges to establish listing standards that, among other things, require each member of a listed issuer’s compensation committee to be “independent” and provide compensation committees with greater authority and responsibilities regarding the selection and engagement of compensation advisers. In addition, proposed amendments to Item 407(e)(3) of Regulation S-K require enhanced disclosure in annual proxy materials regarding compensation consultants and any conflicts of interest that may exist between such consultants and the issuer.

### **INDEPENDENCE OF COMPENSATION COMMITTEE MEMBERS**

Proposed Rule 10C-1 under the Exchange Act requires the national securities exchanges to establish listing standards that require each member of a listed issuer’s compensation committee to be a member of the board of directors and to be “independent.” Although the proposed rules do not define “independence”, they set forth relevant factors that the exchanges should consider in

developing their listing standards, including: (1) 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 (2) whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

In the proposing release, the SEC emphasized that the proposed rules do not themselves establish independence standards or specifically prohibit any category of persons from being considered independent, but instead provide the national securities exchanges with the flexibility to establish their own minimum independence criteria for compensation committee members after considering the relevant factors set forth above. This is a more flexible approach than the independence requirements for audit committee members under the Sarbanes-Oxley Act of 2002, which prohibited persons with certain specified relationships with an issuer, such as affiliates, from serving on the audit committee.

Regardless of the final parameters of the independence standards for compensation committee members to be developed by the exchanges, issuers should be mindful that they will still need to consider the definition of “outside director” under Section 162(m) of the Internal Revenue Code in order to preserve the tax deductibility of performance-based compensation in excess of \$1 million for certain named executive officers, and the definition of “non-employee director” under Section 16 of the Exchange Act for the purpose of exempting equity awards from the short-swing profit rules.

## ENGAGEMENT OF COMPENSATION ADVISERS

Proposed Rule 10C-1 directs the national securities exchanges to prohibit the listing of the equity securities of any issuer that is not in compliance with the following requirements relating to the authority of compensation committees to retain, and their responsibilities with respect to, compensation advisers:

- the compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers;
- the compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser; and
- each listed issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to compensation advisers.

The SEC noted that the proposed rules should not be construed as requiring a compensation committee to retain independent legal counsel or as precluding a compensation committee from retaining non-independent legal counsel or obtaining advice from in-house counsel or outside counsel retained by the issuer or management.

## INDEPENDENCE OF COMPENSATION ADVISERS

The SEC is requiring that the listing standards developed by the national securities exchanges for use in connection with the evaluation and selection of compensation consultants, legal counsel and other advisers must include certain factors relating to the independence of such advisers, including:

- whether the person that employs the compensation consultant, legal counsel or other adviser provided other services to the issuer;
- the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;

- the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; and
- whether the compensation consultant, legal counsel or other adviser owns any stock of the issuer.

The exchanges may also add other independence factors, in addition to the five factors listed above, that compensation committees must consider when selecting compensation advisers.

## EXEMPTIONS

The following categories of issuers are exempt from the compensation committee member independence requirements and, therefore, cannot be delisted for not complying with such requirements: (1) controlled companies; (2) limited partnerships; (3) companies in bankruptcy proceedings; (4) open-end management investment companies registered under the Investment Company Act of 1940; and (5) foreign private issuers that provide annual disclosures to shareholders of the reasons why the foreign private issuer does not have an independent compensation committee.

In addition to these general exemptions from the compensation committee member independence requirements, the SEC would allow the national securities exchanges to propose other exemptions as they deem appropriate, taking into account such factors as the potential impact on smaller issuers. We note that, as proposed, controlled companies would be exempt from all of the requirements of the new compensation committee listing standards, including the compensation committee member independence requirements.

## DISCLOSURES AND CONFLICTS OF INTEREST

The SEC has proposed amendments to Item 407(e)(3) of Regulation S-K that expand the current disclosures regarding compensation advisers that must be included in an issuer's proxy materials for annual meetings (or special meetings in lieu of the annual meeting). Specifically, issuers will be required: (i) to disclose whether their compensation

committee has retained or obtained the advice of a compensation consultant and, if so, to identify such consultant; (ii) to state whether the consultant was engaged directly by the compensation committee (or another board committee performing equivalent functions); and (iii) to describe 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.

A compensation committee would be considered to have "obtained the advice" of a compensation consultant if the committee or management has requested or received advice from the consultant, regardless of whether there is a formal engagement of the consultant, a client relationship with the compensation committee or management, or any payment of fees to the consultant for its advice.

The proposals also require disclosure of whether 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. Although the term "conflict of interest" is not defined, issuers would have to consider the same five factors that are to be considered in evaluating the independence of compensation consultants in determining whether there is a conflict of interest that may require disclosure. Issuers would also need to consider the specific facts and circumstances relating to a consultant's engagement, and may consider other factors, in their determinations of whether there may be a conflict of interest. If the committee determines that a conflict exists, it will need to include a concise and clear description of both the conflict and the manner in which it was addressed, not merely a description of the issuer's general policies and procedures on resolving conflicts.

The SEC's proposal broadens the scope of disclosure regarding compensation advisers currently required by Item 407(e)(3) of Regulation S-K by eliminating the existing exceptions contained therein. Thus, disclosure about a compensation consultant would be required even if the consultant provides only advice on broad-based plans or provides only non-customized benchmark data.

The enhanced disclosure would apply to all listed and unlisted Exchange Act registrants subject to the proxy rules, whether or not they are controlled companies.

## TIMING

Comments on the proposed rules are due by April 29, 2011, and the SEC is required to adopt final rules by July 16, 2011. Once the final rules are published in the Federal Register, the national securities exchanges will have 90 days to provide to the SEC proposed rules or rule amendments that comply with the final version of the rules. These proposals will themselves be subject to review and comment by the SEC. Each exchange would be required to have final rules in place no later than one year after the final version of the rules is published in the Federal Register.

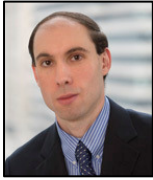
The additional disclosure requirements regarding compensation consultants and conflicts of interest would not be required for proxy or information statements filed in definitive form before the effective date of the rules implementing such disclosures. Thus, the proposed rules will not affect the disclosures for the current proxy season.

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*The foregoing is intended to summarize the SEC's proposed new rules regarding the independence of compensation committee members and advisers, and related disclosure requirements, and does not constitute legal advice. Please contact the Pryor Cashman attorney with whom you work with any questions you may have. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Michael T. Campoli at (212) 326-0468.*

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Michael Campoli devotes his practice to counseling public and private companies on a broad range of corporate matters, including securities law compliance, corporate formation and governance, mergers and acquisitions, public and private debt and equity financing transactions, and limited liability company and partnership counseling.

Mr. Campoli's work at Pryor Cashman has included the representation of:

- Marina Biotech, Inc. (NASDAQ: MRNA) as outside general counsel in connection with various equity and debt financings, M&A initiatives and compliance with the reporting requirements of the Securities Exchange Act
- Dongsheng Pharmaceutical International Co., Ltd. (OTCBB: DNGH) as outside general counsel in connection with its Securities Exchange Act reporting requirements
- Javelin Pharmaceuticals, Inc. (NYSE Amex: JAV) as outside general counsel in connection with various equity financings and compliance with the reporting requirements of the Securities Exchange Act
- Cowen and Company, LLC in the follow-on public offering of units of Bionovo, Inc. (NCM: BNVI) for aggregate gross proceeds of \$30 million
- Global Hunter Securities, LLC and Knight Capital Markets LLC, as joint book-runners, in the initial public offering of 5,000,000 American Depositary Shares of Ossen Innovation Co., Ltd. (NGM: OSN) for aggregate gross proceeds of \$22.5 million
- Rodman & Renshaw, LLC in the follow-on public offering of the common stock of SkyPeople Fruit Juice, Inc. (NGM: SPU) for aggregate gross proceeds of \$25.9 million
- Henry Schein, Inc. (NASDAQ: HSIC) in connection with the acquisition of various private companies in the medical equipment and software industries
- Briad Restaurant Group in its prevailing tender offer for Main Street Restaurant Group, Inc., the largest franchisee of T.G.I. Friday's restaurants
- A private telecommunications company in connection with the issuance of a \$260 million secured note to the Rural Utilities Service of the U.S. Department of Agriculture and the concurrent placement of \$110 million of preferred stock to venture capital investors