

“What keeps you up at night?”

Dodd-Frank law calls for regulations requiring independence of compensation committees

By Marshall B. Paul and Katayun I. Jaffari

SUMMARY

The new Dodd-Frank law mandates that the SEC establish rules to ensure members of the compensation committees of publicly traded companies be independent.

The financial crisis of the last two years, and the enormous bonuses paid by rescued and even failed financial institutions to their top executives, have highlighted the need for, and issues concerning, compensation committee independence.

To address this, Section 952 of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act amends the Securities Exchange Act of 1934 to provide that the SEC must, by rule, direct the national securities exchanges to prohibit the listing of an equity security of a listed company if the listed company does not require (i) every member of the compensation committee (and not just a majority of the members of the compensation committee) to be independent and (ii) every member of the compensation committee to be a member of the board.

The rule to be established by the SEC must provide that, in determining “independence,” the national securities exchanges must consider relevant factors such as the source of compensation of a member of the compensation committee as a member of the board of directors of the listed company, including any consulting, advisory or other compensatory fee paid by the company to the member of the board, and whether the member of the board is affiliated in some other way with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the company.

The rule to be promulgated by the SEC also must permit the national securities exchanges to exempt a particular relationship from the independence requirement if the national securities exchange, at its option, determines this to be appropriate, taking into account the size of the listed company and any other relevant factors.

The final Dodd-Frank provisions concerning compensation committee independence differ from other earlier proposals which would have specifically precluded independence of a compensation committee member if the member was receiving any consulting, advisory or other compensatory fee or was otherwise affiliated with the company or its subsidiary or an affiliate of a subsidiary.

While the scope of the rule to be promulgated by the SEC remains to be seen, it is clear that the statutory requirements themselves are not very different than the best practices currently used by many listed companies. In addition, we will not be surprised if the new independence rules are similar to the rules regarding independence of audit committee members, which went into effect several years ago. We also expect the rules to be promulgated quickly and will keep our readers updated as soon as they are released.

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