



Securities Alert

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SEC Proposes Rules to Require Revised Exchange Listing Standards for Compensation Committees

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The Securities and Exchange Commission (SEC) has proposed rules that would require national securities exchanges to adopt new listing standards related to compensation committees,¹ implementing certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). New Section 10C of the Securities Exchange Act of 1934, as amended (the Exchange Act), added by Section 952 of the Dodd-Frank Act, requires the SEC to adopt rules directing the national securities exchanges to prohibit the listing of any equity security of a company that is not in compliance with Section 10C's compensation committee and compensation adviser requirements, as described below.

The proposed rules would direct the exchanges to establish listing standards that would apply to any committee of the board of directors that oversees executive compensation, but would not require the listing standards to apply to independent directors who oversee executive compensation in lieu of a board committee. Neither the Dodd-Frank Act nor the proposed rules require a public company to establish a separate compensation committee. However, current exchange listing standards generally require listed companies to have a compensation committee or to have independent directors determine, recommend, or oversee specified executive compensation matters. As a result, most public companies have established separate compensation committees, and accordingly will be subject to these rules when they are adopted.

The exchange listing standards will be subject to SEC approval pursuant to Section 19(b) of the Exchange Act. Comments on the proposed rules are due by April 29, 2011.

Independence of Compensation Committee Members

Proposed Rule 10C-1(b)(1)(i) under the Exchange Act would require the exchanges to establish listing standards that, at a minimum, require each member of a listed company's compensation committee to be a member of the board of directors, and to be independent, as defined in the listing standards. "Independence" is not defined in Section 10C or in the proposed SEC rules. However, each of the national securities exchanges currently includes a definition of "independence" for purposes of service on a listed company's board of directors.

The proposed rule will require the exchanges to consider and assess to what extent the definition of independence should be revised to apply specifically to compensation committee members. This assessment may ultimately result in a separate definition or standard of independence for compensation committee members, just as Rule 10A-3 under the Exchange Act requires separate, heightened standards of independence for audit committee members. It is also possible that the

exchanges will each adopt different standards of independence, and there may ultimately be different treatment of relationships and circumstances for this purpose from one exchange to another. The exchanges have the discretion to assess and decide what standards and qualifications of independence are important to them, subject to the SEC's ultimate approval.

Both Section 10C(a)(1) of the Exchange Act and Rule 10C-1(b)(1)(ii) provide that the exchanges should consider the following relevant factors, among others, in defining independence for this purpose:

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

Exchanges are permitted to exempt particular relationships from these independence requirements after taking into consideration the size of a company and any other relevant factors. For example, an exchange may determine that director representatives of significant stockholders should be permitted to serve on the compensation committee because they would be especially vigilant in their oversight of executive compensation. Exchanges are also allowed to exempt any category of issuers from the compensation committee requirements, such as smaller reporting companies. However, in light of the general application by the exchanges of current committee composition requirements to smaller reporting companies, it is unlikely that smaller reporting companies will be exempted entirely from the new requirements related to compensation committees.

Proposed Rule 10C-1(a)(3) also allows for an opportunity to cure defects by providing that the exchanges' listing standards may provide that if a member of a compensation committee ceases to be independent for reasons outside the member's reasonable control, such member, with notice by the company to the applicable exchange, may remain a compensation committee member until the earlier of the next annual meeting of the company's stockholders or one year from the occurrence of the event that caused the member to lose his or her independence status.

Practice Note: Once the exchanges have proposed their listing standards, an assessment should be made of each member of the compensation committee (or other board committee that is charged with the oversight of executive compensation) to determine whether he or she will continue to qualify under the new standards of independence, as well as the existing definitions of "non-employee directors" pursuant to Rule 16b-3(b)(3) under the Exchange Act and "outside directors" pursuant to Section 162(m) of the Internal Revenue Code.

Authority to Engage Compensation Advisers

Proposed Rules 10C-1(b)(2) and 10C-1(b)(3) under the Exchange Act would require the exchanges to establish listing standards that prohibit the listing of a company's securities if a company is not in compliance with the following requirements:

- The company's 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 (collectively, compensation advisers);
- Before selecting any compensation adviser, the company's compensation committee must take into consideration specific factors identified by the SEC that affect the independence of compensation advisers, as set forth below;
- The company's compensation committee must be directly responsible for the appointment, compensation, and oversight of the work of any compensation adviser; and

- The company must provide appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to compensation advisers.

Practice Note: If these rules are adopted in their proposed form, compensation committees will need to ensure that their processes and procedures incorporate the requirement to undertake an assessment of the independence of their compensation advisers prior to selecting any such adviser to work with the committee.

Compensation Adviser Selection

In accordance with Section 10C(b) of the Exchange Act, proposed Rule 10C-1(b)(4) under the Exchange Act would require that the exchange listing standards direct that, at a minimum, the following five independence factors be considered by the compensation committee in selecting compensation advisers:

- Whether the compensation adviser or other entity employing the compensation adviser is providing any other services to the company;
- How much the compensation adviser or other entity employing the compensation adviser has received in fees from the company, as a percentage of the total revenue of the entity that employs the compensation adviser;
- What policies and procedures have been adopted by the entity employing the compensation adviser to prevent conflicts of interest;
- Whether the compensation adviser has any business or personal relationship with a member of the compensation committee; and
- Whether the compensation adviser owns any stock of the company.

The Dodd-Frank Act and the proposed SEC rules do not require that the compensation advisers selected by the compensation committee be independent, but rather require that these factors be considered in determining whether a compensation adviser should be retained.

Practice Note: The SEC notes that it does not propose to have the exchanges include bright-line numerical or other thresholds to be used by compensation committees in assessing the independence of their compensation advisers. For example, under the second bullet point above, the proposed rules do not include a threshold for the amount of fees below which an adviser would be deemed to be independent. Rather, that judgment would be left to the discretion of the compensation committee in light of all other relevant factors.

Exemptions

As directed by the Dodd-Frank Act, the proposed rules would require the exchanges to exempt the following five categories of issuers from the compensation committee independence requirements:

- Controlled companies, which are companies where more than 50% of the voting power in an election of directors is held by an individual, a group, or another company;
- 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 it does not have an independent compensation committee.

Despite the above proposed exemption from the compensation committee independence requirements, assuming proper disclosure, foreign private issuers that have established compensation committees would be required to comply with all other applicable proposed SEC rules related to compensation committees. However, the disclosure requirements described below would not apply to foreign private issuers because they are exempt from the SEC's rules relating to the issuance of proxy statements and related materials under Section 14 of the Exchange Act.

In addition, the proposed rules would not apply to companies whose securities are only traded on the OTC Bulletin Board and the OTC Markets Group (formerly known as the Pink Sheets and Pink OTC Markets), as those systems are not national securities exchanges. Finally, the rules would apply to issuers with listed equity securities, and not to issuers only with listed debt securities.

Disclosure Requirements in Proxy and Information Statements

Section 10C(c)(2) of the Exchange Act requires the SEC to adopt new disclosure rules concerning the use of compensation consultants and conflicts of interest. Accordingly, the SEC proposed amendments to Item 407(e)(3) of Regulation S-K to require disclosure in any proxy or information statement for an annual meeting (or a special meeting in lieu of an annual meeting) of stockholders at which directors are to be elected regarding the following:

- Whether a company's compensation committee retained or obtained the advice of a compensation consultant during the last completed fiscal year, identifying the consultant and describing the work performed;
- Whether the work of the compensation consultant has raised any conflicts of interest; and
- If any such conflicts were raised, the nature of the conflict and how the conflict is being addressed.

Item 407(e)(3) of Regulation S-K currently requires companies that are subject to the proxy rules to provide certain disclosures concerning their compensation committees and the use of compensation consultants. As proposed, amended Item 407(e)(3) would also apply to all companies subject to the proxy rules, including companies not listed on an exchange and controlled companies. Amended Item 407(e)(3) would require a company to disclose whether the compensation committee has retained or obtained the advice of a compensation consultant during the company's last completed fiscal year, instead of the current disclosure of whether a consultant "played a role" in determining or recommending the amount or form of executive or director compensation. Existing exceptions from the disclosure requirements in Item 407(e)(3) for consulting with respect only to broad-based plans that do not discriminate in scope, terms, or operation in favor of executive officers or directors of the company and that are generally available to all employees of the company, or for providing noncustomized benchmark data, would be eliminated under the amended Item 407(e)(3). However, the fee disclosure requirement of Item 407(e)(3) would continue to include the existing exclusions for consulting on any nondiscriminatory, broad-based plan or providing noncustomized information.

The SEC also proposed to include an instruction in the amended Item 407(e)(3) to clarify that the phrase "obtained the advice [of a compensation consultant]" relates to whether a compensation 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 consultant, on the one hand, and the compensation committee or management, on the other, or whether there has been any payment of fees to the consultant for its advice. In addition, the SEC proposed to include an instruction identifying the five independence factors listed above under "Compensation Adviser Selection" as factors that a company should consider, among others, in

determining the existence of a conflict of interest that may require disclosure under amended Item 407(e)(3).

Timing and Transition

Comments on the proposed SEC rules are due by April 29, 2011. The Dodd-Frank Act requires the SEC to issue final rules implementing Section 952 by July 16, 2011. The Dodd-Frank Act did not establish a deadline by which the listing standards promulgated by the exchanges must be in effect. The SEC proposed that each exchange provide it with proposed listing standards within 90 days of the publication of the SEC's final rules in the Federal Register and that each exchange has received approval from the SEC of final listing standards that are compliant with the SEC's final rules within one year of the publication of the final rules in the Federal Register.

It is not yet clear whether the listing standards related to compensation committee independence and advisers will be in effect prior to the 2012 proxy season, but we expect that the disclosure requirements under amended Item 407(e)(3) of Regulation S-K will be in effect.

We will continue to update you regarding further developments with respect to these new rule proposals. In the meantime, please contact the Mintz Levin attorney who advises you regarding securities compliance matters if you have any questions regarding these rule proposals or related matters.

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Endnotes

1 See Release No. 33-9199 available on the SEC's website at <http://sec.gov/rules/proposed/2011/33-9199.pdf>.

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