

JUNE 2012

SEC ADOPTS RULES REQUIRING LISTING STANDARDS FOR COMPENSATION COMMITTEES AND COMPENSATION ADVISERS

On June 20, 2012, the Securities and Exchange Commission (SEC) adopted SEC Rule 10C-1¹ as required by the Dodd-Frank Act of 2010. The rule initially was proposed by the SEC on March 30, 2011. Our previous discussion of the proposed rule can be found in our previous WSGR Alert.²

The rule directs the New York Stock Exchange, the NASDAQ Stock Market, and other national securities exchanges to establish listing standards that:

- define standards of independence applicable to compensation committee members and directors who oversee executive compensation matters outside of the structure of a formal board committee;
- require each member of a listed issuer's compensation committee to be an independent member of the board of directors;
- require consideration of specified factors by a listed issuer's compensation committee relating to the independence of any compensation advisers; and
- specify the authority and responsibilities of the compensation committee over the appointment, compensation, and oversight of the work of any compensation adviser.

The SEC also amended the proxy disclosure rules of Regulation S-K to require new disclosures about the services provided by compensation advisers and conflicts of interest.

The New Listing Requirements

Applicability

Under the rule, the listing standards to be adopted by the national securities exchanges shall be applicable to:

- any formally designated "compensation committee";
- in the absence of a designated compensation committee, any committee of the board that performs functions typically performed by a compensation committee, including oversight of executive compensation, whether or not such committee also performs other functions; and
- in the absence of both of the previous two committees, those members of a listed issuer's board of directors who oversee executive compensation matters on behalf of the board of directors in lieu of such a board committee, with limited exceptions.³

In this WSGR Alert, unless otherwise specified, references to a listed company's "compensation committee" include all of the above categories.

Compensation Committee – Independence Requirements

Under the rule, the exchanges must adopt listing standards that require each member of a listed issuer's compensation committee to be independent and that define independence for this purpose. In developing definitions of independence, the exchanges will be required to consider relevant factors, including, but not limited to:

- the source of a director's compensation, including any consulting, advisory, or other compensatory fees paid by the issuer; and
- whether a director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

Similar to the proposed rules, the final rules do not define independence. Instead, they give the national securities exchanges flexibility to establish minimum independence criteria for compensation committee members, subject to the approval of the SEC. Notably, unlike the independence criteria

¹The complete rule can be found at <http://www.sec.gov/rules/final/2012/33-9330.pdf>.

²The WSGR Alert is available at http://www.wsgr.com/publications/pdfsearch/wsgralert_sec_listing_standards.pdf.

³The limited exceptions include listing standards described elsewhere in this alert relating to the compensation committee's authority to retain compensation advisers and required funding for payment of such advisers.

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applicable to members of a listed company's audit committee (see Section 10A of the Exchange Act), the rule does not require the national securities exchanges to adopt listing standards prohibiting a director who receives compensatory fees from the issuer or who is an affiliate from being independent.

Compensation Advisers – Authority and Funding

Under the rule, the exchanges must adopt listing standards providing that the compensation committee:

- may, in its sole discretion, retain or obtain the advice of compensation consultants, independent legal counsel, and other advisers (collectively, "compensation advisers");
- is directly responsible for the appointment, compensation, and oversight of compensation advisers; and
- must be appropriately funded by the listed company, as determined by the compensation committee, for payment of reasonable compensation to compensation advisers (whether or not such advisers are independent).

The rule does not require a compensation committee to retain independent legal counsel. Compensation committees may choose to receive advice from non-independent legal counsel, including in-house counsel or outside counsel retained by the issuer or management.

Compensation Advisers – Independence

Under the rule, the exchanges must adopt listing standards providing that the compensation committee may select a compensation adviser only following consideration of the following six independence factors:

- Whether the compensation consulting company employing the compensation adviser is providing any other services to the company
- The amount of fees received from the company by the compensation consulting

company that employs the compensation adviser, as a percentage of total revenue

- What policies and procedures have been adopted by the compensation consulting company 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
- Whether the compensation adviser owns any stock of the company
- Whether the compensation adviser or the person employing the adviser has any business or personal relationship with an executive officer of the issuer

The sixth independence factor adopted by the rule was added following the release of the proposed rule. Additional required independence factors may be adopted by the exchanges, subject to the approval of the SEC.

While the compensation committee must consider each required factor prior to engaging a compensation adviser, any determination of independence should be made upon the totality of the review with no individual factor being necessarily determinative. Furthermore, neither the Exchange Act nor the rule requires that a compensation adviser be found to be independent. A compensation committee need not consider these independence factors before consulting with or obtaining advice from in-house counsel.

Curing Defects

The rule requires the exchanges to establish procedures (if existing procedures are not adequate) to cure any failure to comply with the listing requirements prior to the prohibition of listing or delisting any security of a listed company. The SEC has noted that it believes the existing listing and delisting procedures of most exchanges satisfy this requirement.

As with violations of the independence requirements applicable to audit committee members, the exchanges may establish rules providing that if a member of a compensation committee ceases to be independent for reasons outside of that member's reasonable

control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member of the listed company until the earlier of the next annual meeting of the listed company or one year from the occurrence of the event that caused the member to cease to be independent.

Exemptions

The rule specifically exempts controlled companies and smaller reporting companies from all of the new listing standards and further authorizes the exchanges to exempt other categories of issuers and particular relationships, subject to the approval of the SEC. The broad exemption of controlled companies and smaller reporting companies was added following the release of the proposed rule.

In addition, the rule requires the exchanges to exempt the following four categories of companies from the new compensation committee independence listing standards:

- limited partnerships,
- companies in bankruptcy proceedings,
- open-end management investment companies registered under the Investment Company Act of 1940, and
- foreign private issuers that disclose in their annual reports the reasons that they do not have independent compensation committees.

Compensation Advisers – Conflicts of Interest Disclosure Requirements

Under current federal proxy statement rules, issuers that are subject to the SEC's proxy statement rules are required to provide certain disclosures concerning their compensation committees and the use of compensation advisers, subject to limited exceptions (see, e.g., Item 407(e)(3)(iii) of Regulation S-K). In adopting the rule, the SEC created a new Item 407(e)(3)(iv) of Regulation S-K requiring that each issuer disclose, with respect to any compensation adviser that is identified pursuant to Item 407(e)(3)(iii) as having played a role in determining or recommending the

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amount or form of executive and director compensation, whether the work of the compensation adviser raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

New subparagraph (iv) will apply to all issuers subject to SEC proxy statement rules, including controlled companies, non-listed issuers, and smaller reporting companies, but excluding foreign private issuers not subject to SEC proxy statement rules.

The SEC did not adopt the proposed amendments that would have eliminated the disclosure exception applicable to compensation advisers consulting on broad-based plans and the provision of non-customized benchmark data. Instead, new subparagraph (iv) relies upon the existing disclosure triggers of subparagraph (iii) rather than the proposed trigger relating to compensation committees that "obtained or retained the advice" of a compensation adviser. Notably, use of the subparagraph (iii) disclosure trigger extends the proposed disclosure regarding compensation advisers to include services relating to director compensation, whereas the proposed amendment would have extended it only to executive compensation.

Transition and Timing

The rule and amendments to Item 407 of Regulation S-K will be effective approximately one month from now, at the end of July 2012. The national securities exchanges then will have 90 days to propose listing standards that comply with the rule (approximately by the end of September 2012). These listing standards must be

approved by the SEC before the first anniversary of effectiveness (approximately the end of July 2013).

Issuers must comply with the amendments to Item 407 in any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) occurring on or after January 1, 2013, at which directors will be elected.

What You Should Do Now

The new listing standards probably will not become effective until sometime in 2013, as the exchanges must first publish proposed listing standards, solicit comments, and obtain SEC approval. Until the new listing standards are final, it is difficult to know exactly what minimum standards of independence for compensation committees and compensation consultants will apply. WSGR will provide an additional update once the exchanges propose listing standards that comply with the rules, which we expect to occur by the end of September 2012.

For the time being, we suggest that companies inform their boards of directors and compensation committees that the rules have been adopted and provide them with the expected timetable for the new listing standards.

For any questions or for more information on these or any related matters, please contact your regular Wilson Sonsini Goodrich & Rosati contact or any member of the firm's corporate and securities or employee benefits and executive compensation practices.



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