

WSGR ALERT

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SEC PROPOSES RULES REQUIRING LISTING STANDARDS FOR COMPENSATION COMMITTEES AND COMPENSATION CONSULTANTS

On March 30, 2011, the Securities and Exchange Commission (SEC) unanimously voted to propose rules that would, among other things, direct the national securities exchanges to adopt listing standards relating to the independence of a listed company's compensation committee of the board of directors and the authority of the committee to hire compensation consultants and other advisers. The proposed rules also would require enhanced and additional disclosures from companies regarding the use of compensation consultants and other advisers and conflicts of interests. The proposed rules implement the provisions of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which adds Section 10C to the Securities Exchange Act of 1934 (the Exchange Act).

Once an exchange's new listing standards are in effect, a listed company must meet these standards in order for its shares to continue trading on that exchange.

The Proposed Listing Requirements

Applicability

Neither Section 10C of the Exchange Act nor SEC rules require a listed issuer to have a compensation committee or a committee that performs functions typically assigned to a compensation committee. Current exchange listing standards, however, generally require listed issuers either to have a compensation committee or to have independent directors

determine, recommend, or oversee specified executive compensation matters.

Under the SEC's proposal, the exchanges would be directed to adopt listing standards that would be applicable to any committee of the board that oversees executive compensation, whether or not the committee performs multiple functions and/or is formally designated as a "compensation committee." However, these listing standards would not be applicable to independent directors who oversee executive compensation in lieu of a board committee, since Section 10C of the Exchange Act refers only to compensation committees.

Independence Requirements

Under current SEC rules, there is no independence requirement for compensation committee members, although the listing standards of the exchanges generally require members of a compensation committee to meet general independence requirements. The proposed rules would require each member of a listed company's compensation committee to be an independent director of the company. The proposed rules also would direct the exchanges to develop a definition of independence applicable to compensation committee members after considering relevant factors, including, but not limited to:

- the source of compensation of a director, including any consulting, advisory, or other compensatory fee paid by the issuer to such director; and

- whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

The national securities exchanges will retain the flexibility to establish additional minimum independence criteria for compensation committee members, and the exchanges may add other factors as it deems appropriate, subject to the approval of the SEC.

Compensation Consultants and Other Advisers – Authority and Funding

The proposed rules would provide that a compensation committee of a listed issuer may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel, and other advisers (collectively, "compensation advisers"). Additionally, the compensation committee would be directly responsible for the appointment, payment, and oversight of compensation advisers. The proposed rules also would require a listed issuer to provide "appropriate funding," as determined by the compensation committee, for payment of "reasonable compensation" to compensation advisers.

The proposed rules would not, however, require a compensation committee to retain independent legal counsel, nor would the proposed rules preclude a compensation committee from retaining non-independent legal counsel or obtaining advice from an in-house counsel or outside counsel retained by the issuer or management.

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Compensation Consultants and Other Advisers – Independence

The proposed rules would not require that compensation advisers selected by the compensation committee of a listed issuer be independent—the rules would only require that the compensation committee consider factors that may bear upon independence before making a selection of compensation advisers.

Specifically, the proposed rules would mandate that the listing standards developed by the exchanges require compensation committees to consider relevant factors, which must include, but are not limited to:

- the provision of other services to the issuer by the person who employs the compensation adviser;
- the amount of fees received from the issuer by the person who employs the compensation adviser as a percentage of the total revenue of the person who employs the compensation adviser;
- the policies and procedures of the person who employs the compensation adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation adviser with a member of the compensation committee; and
- any stock of the issuer owned by the compensation adviser.

The SEC believes that the factors set forth are generally comprehensive, but under the proposed rules, the exchanges may add other independence factors that must be considered.

Cure Defects

The proposed rules would require that the exchanges establish procedures to permit issuers to cure defects (if existing procedures are not adequate) before they prohibit the listing of, or delist, any security of a listed company for failure to comply with the proposed listing requirements. The SEC

believes that the existing listing and delisting procedures of most of the exchanges would satisfy the requirement for there to be reasonable procedures to cure defects.

The proposed rules also would mirror the current provisions for curing violations of the independence requirements for audit committee members—the exchanges' rules may provide that if a member of a compensation committee ceases to be independent for reasons outside the 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 no longer be independent.

Exemptions

The proposed rules would require the exchanges to exempt the following five categories of companies from the compensation committee independence requirements:

- controlled companies
- 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 the reasons it does not have an independent compensation committee

Additionally, the proposed rules would give the exchanges the authority to exempt a particular relationship from the compensation committee independence requirements, as such exchange deems appropriate.

Proposed Enhanced Disclosure Requirements

Under the current federal proxy rules, issuers that are subject to the proxy rules are

required to provide certain disclosures concerning their compensation committees and the use of compensation consultants (see, e.g., Item 407 of Regulation S-K). The proposed rules would revise Item 407(e)(3) of Regulation S-K to also require disclosure about whether the compensation committee has retained or obtained the advice of a compensation consultant, and 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.

The proposed rules also would eliminate the current disclosure exception for services that are limited to consulting on broad-based plans and the provision of non-customized benchmark data, but would retain the fee disclosure requirements, including the exemptions from those requirements.

To trigger such a disclosure under the revised Item 407(e)(3)(iii), the registrant would have retained or obtained the advice of a compensation consultant during the registrant's last completed fiscal year. The SEC has indicated that "obtained the advice" 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 or any payment of fees.

Transition and Timing

The comment period for the proposed rules expires April 29, 2011. Section 952 of the Dodd-Frank Act requires the SEC to adopt final rules regarding these matters no later than July 16, 2011. While the Dodd-Frank Act does not establish a specific deadline by which the listing standards promulgated by the exchanges must be in effect, the SEC has proposed that each exchange provide to the SEC its proposed rules or rule amendments no later than 90 days after publication of the final SEC rules in the Federal Register (i.e., in October 2011, if the final SEC rules are published in the Federal Register in July 2011). Furthermore, each exchange would

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need to have final rules or rule amendments that comply with the SEC final rules approved by the SEC no later than one year after publication of the final SEC rules in the Federal Register (i.e., in July 2012, if the final SEC rules are published in the Federal Register in July 2011).

The new compensation consultant and conflict-of-interest disclosures would not be required for proxy or information statements filed in definitive form before the effective date of the final SEC rules implementing the new disclosures.

What You Should Do Now

Even though it appears that the implementation of the proposed rules could take place as late as the middle of 2012, there are several steps companies can take now to prepare:

- Consider commenting on the proposed rules before the April 29, 2011, deadline.
- Review the independence of your current compensation committee members against the standards proposed in the rules.
- Review the independence of, and conflicts of interest with, your current compensation consultants against the standards proposed in the rules.
- Prepare to update your D&O questionnaires, compensation committee charter and policies, and proxy disclosure following adoption of the proposed rules.

For any questions or 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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