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SEC Proposes New Rules Calling For Greater Independence Standards for Compensation Committees and Their Advisors

In accordance with the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (the “Reform Act”) and its own [timetable](#) for proposing regulations required by section 952 of the Reform Act, the Securities and Exchange Commission (the “SEC”) on March 30, 2011 issued a [press release](#) and published [proposed rules \(Release No. 33-9199\)](#) (the “Proposed Rules”) for compensation committee and compensation advisor independence requirements.

As we previously commented (see our blog from [July 26, 2010 “The Regulatory March to Reform Executive Compensation Practices Takes Another Step Forward”](#)), the Reform Act implemented numerous new laws affecting executive compensation and corporate governance at publicly-held companies. Section 952 of the Reform Act added Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”). Among other things, Section 10C requires the SEC to adopt rules directing the national securities exchanges and national securities associations (the “Exchanges”) to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C’s compensation committee and compensation adviser independence requirements.

Section 10C essentially provides that limited partnerships, companies in bankruptcy proceedings, open-end management investment companies registered under the Investment Company Act of 1940, and foreign private issuers that provide annual disclosures to shareholders of the reasons why the foreign private issuer does not have an independent compensation committee will not be subject to the Exchanges’ listing requirements regarding compensation committee member independence. Section 10C further expressly provides that controlled companies are exempt from its requirements.

The SEC is responding to the requirements of Section 10C by releasing the Proposed Rules which includes new Exchange Act Rule 10C-1 that addresses the Exchanges’ listing standards for compensation committees and related independence requirements. The Proposed Rules would also amend the compensation committee consultant disclosure requirements of Item 407(e) of Regulation S-K. The SEC has

solicited the public for comments by April 29, 2011 in numerous areas of the Proposed Rules in order to help them in their process of adopting final rules ("Final Rules").

Below is a brief overview of the Proposed Rules.

COMPENSATION COMMITTEE - INDEPENDENCE REQUIREMENTS

The Proposed Rules would compel the Exchanges to establish listing standards that require each member of a listed issuer's compensation committee to be: (i) a member of the board of directors and (ii) "independent." The term "independent" is not defined in the Proposed Rules. Instead, the Proposed Rules provide that "independent" is to be defined by the Exchanges after taking into consideration "relevant factors" which shall include, but are not limited to:

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

The Exchanges are given the flexibility to establish their own minimum independence criteria for compensation committee members after considering the relevant factors enumerated above. An Exchange may add other factors subject to approval by the SEC. The Proposed Rules would authorize the Exchanges to establish listing standards that exempt particular relationships between members of the compensation committee and listed issuers that might otherwise impair the member's independence, taking into consideration the size of an issuer and any other relevant factors.

It is interesting to note that the existing independence requirements for audit committee members under Exchange Act Rule 10A-3 and the Proposed Rules' requirements for compensation committee members are generally similar, although there is at least one significant difference which relaxes the independence standards for compensation committees. With respect to defining compensation committee member independence, the Exchanges will only have to consider the above relevant factors. In contrast, the SEC's rules for audit committee independence prescribe specific minimum criteria and permit the Exchanges to adopt even more stringent independence requirements if desired. Thus, an audit committee member cannot accept any consulting, advisory or

other compensatory fee and cannot be an affiliated person of the issuer or its subsidiaries. This could be an important difference since, for example, a director who is a member of a venture capital firm or private equity fund which is a major investor of the issuer and who therefore is deemed to be an affiliate of the issuer may still be able to serve on the compensation committee whereas he/she would be unable to serve on the audit committee.

Compensation Committee – Authority and Funding

The Proposed Rules include a number of requirements that are intended to ensure that the compensation committee has the requisite authority and autonomy to perform its role. These include the following:

- Each 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”);
- Each compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser; and
- Each issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to compensation advisers.

COMPENSATION ADVISERS - INDEPENDENCE REQUIREMENTS

The Proposed Rules will require that the Exchanges' listing standards provide that the compensation committee may select a compensation adviser only after taking into consideration the competitively neutral independence factors set forth below. The Exchanges may add other independence factors that must be considered by the compensation committees of their listed issuers. The Proposed Rules do not require a compensation adviser to be independent, only that the compensation committee consider the below factors before selecting a compensation adviser (whether it is a compensation consultant, legal counsel or other adviser). Such independence factors are:

- The provision of other services to the issuer by the person that employs the compensation adviser;
- 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 adviser;
- The policies and procedures of the person that 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.

OPPORTUNITY TO CURE DEFECTS BEFORE DELISTING

Consistent with the requirements of Section 10C, the Proposed Rules will require the Exchanges to establish procedures (if their existing procedures are not adequate) before the Exchange can prohibit the listing of, or delist, any security of an issuer.

Moreover, 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 issuer until the earlier of the next annual meeting of the listed issuer or one year from the occurrence of the event that caused the member to no longer be independent.

EXEMPTIONS FROM LISTING STANDARDS

In addition to the exemptions from the compensation committee independence rules provided by the Reform Act and which are mentioned above, the Proposed Rules provide some additional exemptions from the listing standards including the following.

- The listing standards are intended to apply only to issuers with listed equity securities. Accordingly, listed issuers with only debt securities would not be

subject to these listing rules.

- Issuers of security futures products and standardized options are exempted from the listing standards.
- The Exchanges may exempt a category of issuers from the listing requirements as each Exchange determines is appropriate. In determining appropriate exemptions, the Exchanges are required by Section 10C to take into account the potential impact of the requirements of the Final Rules on small reporting issuers.

COMPENSATION CONSULTANTS - DISCLOSURE AND CONFLICTS OF INTEREST

Amendments to Item 407 of Regulation S-K. The Proposed Rules' amendments to Item 407 of Regulation S-K would require the following disclosures in any proxy or information statement relating to an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors are to be elected. These new disclosure rules would apply to all issuers (including without limitation, controlled companies) subject to the SEC's proxy statement reporting requirements.

- Disclose whether the issuer's compensation committee "retained or obtained" the advice of a compensation consultant during the issuer's last completed fiscal year.
 - The phrase "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 of the consultant or a client relationship between the compensation consultant and the compensation committee or management or any payment of fees to the consultant for its advice.
- Disclose whether the work of the compensation consultant raised any conflict of interest.
 - The term "conflict of interest" is not defined. However, the Proposed Rules include an instruction that identifies the factors set forth above in assessing compensation adviser independence as among the factors that issuers should consider in determining whether there is a conflict of

interest that may need to be disclosed.

- Disclose the nature of any conflict of interest and how the conflict is being addressed.
 - If a compensation committee determines that there is a conflict of interest with the compensation consultant, then the issuer must provide a clear, concise and understandable description of the specific conflict and how the issuer addressed it.

The proposed amendments would also eliminate the existing exception from the requirement to identify compensation consultants and describe their engagement for those cases in which a consultant's role is limited to consulting on a broad-based plan for providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice.

SMALLER REPORTING COMPANIES

As written, the Proposed Rules would apply to smaller reporting companies. However, the SEC has sought comment on whether smaller reporting companies should be exempt from any of the above-proposed disclosure requirements or to scale the proposed amendments to reflect the characteristics of small entities and the needs of their investors in the Final Rules. Further, as noted above, the Proposed Rules permit the Exchanges to exempt particular categories of issuers, including smaller reporting companies, from the rules or rule amendments they adopt in compliance with the Proposed Rules.

TIMING

The Final Rules must be adopted by July 16, 2011. To facilitate timely implementation of the Final Rules, the SEC has proposed that each Exchange provide to the SEC, no later than 90 days after publication of the Final Rules in the Federal Register, proposed rules or rule amendments that comply with the Final Rules. Further, each exchange would need to have final rule or rule amendments that comply with the SEC's Final Rules no later than one year after publication of the Final Rules in the Federal Register. The new disclosure requirements of Item 407 presumably will become applicable to definitive proxy statements that are filed after the publication of the Final Rules.

WHAT NEXT?

Companies may wish to start reviewing the independence and potential conflicts of interest for each of their compensation committee members, compensation consultants, compensation committee legal counsel and any other advisors in light of the relevant factors cited in the Proposed Rules. While the Final Rules may not require independent compensation advisors, a company's ability to affirmatively disclose that such advisors are all independent will presumably be more favorably received by investors and proxy voting advisors and may assist a company with obtaining a more positive Say-on-Pay vote in future years.

If you have any questions regarding this information, please contact [Greg Schick](#) at (415) 774-2988 or [Nicole Slattery](#) at (858) 720-7467.

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