

April 4, 2011

SEC Proposes Rules Requiring Listing Standards Related To Compensation Committees and Compensation Consultants

On March 30, 2011, the Securities and Exchange Commission proposed rules implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to (1) direct the national securities exchanges to adopt certain listing standards related to the compensation committee of a listed company's board of directors and its compensation advisers and (2) require new disclosures from listed companies concerning their use of compensation consultants and conflicts of interest.

Section 952 of the Dodd-Frank Act added Section 10C to the Securities Exchange Act of 1934 which requires the SEC to adopt rules directing the exchanges to prohibit the listing of any equity security of a company that is not in compliance with Section 10C's requirements.

SEC's Proposed Rules

The SEC's proposed rules direct the exchanges to adopt listing standards that would be applicable to any committee of a listed company's board that oversees executive compensation, whether or not the committee performs multiple functions or is formally designated as a "compensation committee". Because neither the Dodd-Frank Act nor the Exchange Act defines the term "compensation committee", this proposed rule is intended to capture board committees that perform these functions and to avoid the possibility that a listed company might avoid the proposed requirements merely by assigning a different name to a committee that is functionally equivalent to a compensation committee. The proposed rules do not require the listing standards to apply to those independent directors who oversee executive compensation in lieu of a board committee, as permitted by the listing rules of certain exchanges.

Independence of Compensation Committee Members

The SEC's proposed rules require each member of a listed company's compensation committee to be a member of its board of directors and to be independent. The proposed rules do not define "independence" and each exchange would be required to develop a definition of "independence" applicable to compensation committee members after "considering" relevant factors, including, without limitation, the following:

- The sources of compensation of a director, including any consulting, advisory or compensatory fee paid by the company to such member of the board of directors; and

- Whether a member of the board of directors of a company is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

While Section 10C generally provides the compensation committee counterpart to the audit committee independence requirements of Section 10A, there are certain differences. For example, Section 10C requires only that the exchanges “consider” relevant factors described above in formulating independence criteria for compensation committee members, whereas Section 10A(m) (which addresses audit committee member independence criteria) expressly states that certain relationships preclude independence. As a result, the exchanges have more flexibility to establish their own independence criteria for compensation committee members than they have for determining independence criteria for audit committee members, including consideration of additional factors, subject to the SEC’s approval of the listing standards.

Pursuant to Section 10C, the SEC’s proposed rules require each exchange to exempt the following five categories of companies from the compensation committee independence requirements under its listing standards:

- Controlled companies;
- 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 the foreign private issuer does not have an independent compensation committee.

The SEC’s proposed rules also permit each exchange to determine, as appropriate, whether to exempt other categories of listed companies (not identified above) from the compensation committee independence requirements to be reflected in each exchange’s listing standards, taking into account the potential impact of the requirements of Section 10C on smaller reporting companies.

Authority to Appoint Compensation Advisers; Funding of the Compensation Committee

The SEC’s proposed rules require that each exchange adopt listing standards that meet the following requirements set forth in Section 10C:

- The compensation committee of a listed company may, in its sole discretion, retain or obtain the advice of a compensation adviser (which would include compensation consultants, independent legal counsel and other advisers);
- The compensation committee of a listed company shall be directly responsible for the appointment, compensation, and oversight of the work of compensation advisers; and

- The listed company will provide “appropriate funding” as determined by the compensation committee, for the payment of “reasonable compensation” to the committee’s compensation advisers.

Compensation Adviser Independence

The SEC’s proposed rules require that each exchange adopt listing standards that would require a compensation committee to consider, at a minimum, the following five independence factors when considering engaging a compensation adviser (which would include compensation consultants, independent legal counsel and other advisers):

- The provision of other services to the listed company by the person that employs the compensation adviser;
- The amount of fees received from the listed company by the person that employs the compensation 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 listed company owned by the compensation adviser.

Section 10C does not require a compensation adviser or the firm that employs the compensation adviser to be independent; however, it does require that the compensation committee “consider” these independence factors before selecting a compensation adviser. As a result, the SEC’s proposed rules do not require that the listing standards to be developed by the exchanges incorporate any materiality or bright-line thresholds for purposes of considering the independence factors. The proposed rules do permit the exchanges to add other independence factors that must be considered by compensation committees of listed companies.

Compensation Consultant Disclosure and Conflicts of Interest

The SEC’s proposed rules integrate Section 10C’s compensation consultant disclosure requirements into the current compensation consultant disclosure requirements found in Item 407(e)(3) of Regulation S-K for registrants subject to the SEC’s proxy rules. Consequently, the new disclosure requirements apply to all Exchange Act registrants subject to the SEC’s proxy rules, not just listed companies. The proposed rules require that any proxy or information statement relating to an annual meeting of shareholders at which directors are to be elected (or special meeting in lieu of the annual meeting) include the following information:

- Whether an issuer’s 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.

While the term “conflict of interest” is not defined in Section 10C and the SEC’s proposed rules do not supply a definition, the SEC proposes including an instruction that identifies the same five factors to be considered for compensation adviser independence as among the factors that companies should consider in determining whether there is a conflict of interest that may need to be disclosed under Item 407(e)(3).

The proposed amendment to Item 407(e)(3) eliminates the exception from the disclosure requirement of any role of compensation consultants limited to consulting on any broad-based plans or providing non-customized benchmark data. The effect of this proposed rule change is to broaden the scope of disclosure currently required by Item 407(e)(3).

Comments on the proposed rules may be submitted to the SEC until April 29, 2011. A complete copy of the SEC’s proposed rules release may be found at www.sec.gov/rules/proposed/2011/33-9199.pdf.

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