

Corporate Alert

April 8, 2011

SEC Proposes Rules Requiring Listing Standards for Compensation Committees and Compensation Consultants

On March 30, 2011, the Securities and Exchange Commission (SEC) proposed new rules that would require the national securities exchanges to adopt new listing standards regarding compensation committees and compensation consultants. The new rules are in response to a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act that added a new Section 10C to the Securities Exchange Act of 1934. Section 10C requires the SEC to adopt rules directing the exchanges to prohibit the listing of equity securities of an issuer not in compliance with the compensation committee and compensation adviser requirements of such statute. The proposed rules largely repeat the requirements of Section 10C, leaving the development of the listing standards to the exchanges. The SEC, however, is expected to work with the exchanges in crafting the new standards, and any standards proposed by the exchanges will be subject to SEC approval.

The proposed rules should not have any effect on the current proxy season. The SEC is seeking comments on the proposed rules by April 29, 2011, and the SEC is required to adopt final rules by July 16, 2011. The exchanges will have 90 days after publication of the final rules in the *Federal Register* to propose their listing standards, which will then be subject to approval by the SEC. The exchanges will need to have final listing standards in place within one year after the SEC's final rules are published in the *Federal Register*. The proposed rules contain additional disclosure requirements regarding compensation consultants and conflicts of interests, but these additional disclosures will not be required in proxy statements filed in definitive form before the effective date of the rules.

Compensation Committee Member Independence

In the proposed rules, the SEC directs the exchanges to adopt listing standards that require each compensation committee member¹ to be (i) a member of the board of directors and (ii) independent. While the proposed rules do not define "independence," they list certain relevant factors from Section 10C(a)(1) for the exchanges to consider in their determination of a definition, in particular—

- the source of compensation of an issuer's board member, including any consulting, advisory or other compensatory fee paid by the issuer to such board member

¹ While the SEC does not believe that Section 10C of the Exchange Act requires an issuer to establish a compensation committee, the proposed rules would apply to any committee that performs compensation-related activities, such as overseeing executive compensation, whether or not such committee is formally designated as such. The resulting listing standards would not, however, apply to independent directors who oversee executive compensation in situations in which a committee is not used. The New York Stock Exchange requires listed issuers to have compensation committees, but Nasdaq allows executive compensation to be determined (or recommended to the board) either by an independent committee or by a majority of the board's independent directors by separate vote.

- whether an issuer's board member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

This approach is more flexible than the independence requirements for audit committee members under the Sarbanes-Oxley Act of 2002, set forth in Section 10A(m) of the Exchange Act, which prohibit audit committee members from receiving any consulting, advisory or other compensatory fee from the issuer (other than as a member of the audit committee) or from being an affiliate of the issuer or any subsidiary of the issuer. Consequently, the proposed rules do not contain a safe harbor for affiliate status. In the proposing release, the SEC explained that the exchanges may determine that it is appropriate that representatives of significant shareholders be permitted to serve on compensation committees, as some commentators had noted that the interests of major shareholders are generally aligned with those of other shareholders with respect to executive compensation.

As provided in the Dodd-Frank Act, certain categories of companies are exempt from these compensation committee member independence requirements:

- controlled companies (i.e., companies in which more than 50 percent of the voting power in the election of directors is held by an individual, a group or another issuer)
- 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 why it does not have an independent compensation committee.

In addition, the proposed rules allow the exchanges to exempt (i) a particular relationship from the compensation committee member independence requirements, as appropriate, taking into account the size of the issuer and other relevant factors and/or (ii) any category of company from all of the requirements of the new compensation committee listing standards. The proposed rules would exempt controlled companies from all of the requirements of the new compensation committee listing standards.

The proposed rules would direct the exchanges to prohibit the listing of any equity security of an issuer not in compliance with these independence requirements, as required by the statute. Nevertheless, as required by Section 10C, issuers must have a reasonable opportunity to cure any defects that would result in the delisting or prohibition of the listing of such issuer's securities because of the failure to meet the new requirements. Therefore, an exchange may allow a compensation committee member who ceases to be independent for reasons outside such member's reasonable control to remain a member until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member to be no longer independent, with notice to the applicable exchange by the issuer.

Compensation Committee Authority to Retain and Responsibility Regarding Compensation Advisors

In the proposed rules, the SEC also directs the exchanges to adopt listing standards regarding the authority of compensation committees to retain compensation advisors, as well as such compensation committees' responsibilities regarding such compensation advisors. Specifically, the exchanges must adopt listing standards requiring issuers to comply with the following requirements regarding compensation committees—

- The committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisors (collectively, “compensation advisers”).
- Before selecting any compensation adviser, the committee must take into consideration specific factors identified by the SEC that affect the independence of compensation advisers.
- The committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser.
- Each listed issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the committee, to compensation advisers

While the Dodd-Frank Act does not require compensation advisers to be independent, with respect to the independence factors to be considered by compensation committees before selecting a compensation adviser, such committees do have to consider, at a minimum, the following factors set forth in the Dodd-Frank Act—

- whether the person who employs the compensation adviser is providing any other services to the issuer
- how much the person who employs the compensation adviser has received in fees from the issuer, as a percentage of that person's total revenue
- which policies and procedures that are designed to prevent conflicts of interest have been adopted by the person employing the compensation adviser
- 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 issuer.

The SEC declined to impose any bright-line cutoff or materiality thresholds to determine independence, but the exchanges may require the consideration of additional factors.

Disclosure Regarding Compensation Advice Obtained and Conflicts of Interest

Finally, pursuant to the proposed rules, issuers will have to expand their disclosure in any proxy or information statements for shareholder annual meetings (or a special meeting in lieu of an annual meeting) at which directors are to be elected. Currently, Item 407(e)(3) of Regulation S-K requires registrants that are subject to the proxy rules to provide certain disclosure regarding their compensation committees and the use of compensation consultants, including details about the fees paid to compensation consultants. The additional disclosure requirements, which will be integrated with these existing provisions, would require disclosure of whether (i) the compensation committee retained or obtained the advice of a compensation consultant and (ii) the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed.

The phrase “obtained the advice” refers to whether a compensation committee has requested or received advice from a compensation consultant, regardless of whether there was a formal engagement, a relationship with such committee or management, or payment of any fees. Furthermore, while the proposed rules do not include a definition of “conflict of interest,” an instruction would be added advising companies to consider the five independence factors discussed above in determining whether there is a conflict of interest that may need to be disclosed. Nevertheless, issuers will also need to consider the specific facts and circumstances and may consider other factors in their determinations of whether a consultant’s engagement may present a conflict of interest that needs to be disclosed. If the committee determines that a conflict of interest exists, it will need to include a concise and clear description of both the conflict and the manner in which it was addressed, not merely a description of the issuer’s general policies and procedures on resolving conflicts.

These disclosure requirements will apply to Exchange Act registrants subject to the SEC’s proxy rules, whether they are listed or not and whether they are controlled companies or not. The proposed rules would eliminate the current exception for disclosure when a compensation consultant only provides advice regarding broad-based plans or noncustomized benchmark data. Fee disclosure, however, would still not be required if the compensation consultant’s services related only to broad-based plans or noncustomized benchmark data, and no advice was given.

The additional disclosure requirements regarding compensation consultants and conflicts of interests would not be required in proxy or information statements filed in definitive form before the effective date of the new rules, so the proposed rules will not affect the disclosures for the current proxy season.

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