

SEC Proposes New Rules Regarding Compensation Committees and Compensation Advisers

On March 30, 2011, the Securities and Exchange Commission (“SEC”) proposed new rules (the “Proposed Rules”) that would direct the national securities exchanges (the “exchanges”) and national securities associations to adopt certain listing standards regarding compensation committees and compensation advisers.¹ The Proposed Rules would also require new disclosures in proxy statements concerning the use of compensation consultants and conflicts of interest. The new rules were proposed in order to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which added Section 10C to the Securities Exchange Act of 1934 (“Exchange Act”).² The Proposed Rules largely mirror the statutory requirements and delegate to the exchanges the task of developing their own rules.

As noted by the SEC in the Proposing Release, current exchange listing standards generally require listed issuers either to have a compensation committee or to have independent directors determine, recommend or oversee specified executive compensation matters. For example, the New York Stock Exchange (“NYSE”) requires a listed issuer to have a compensation committee composed solely of independent directors and to assign various executive compensation-related tasks to that committee. On the other hand, the NASDAQ Stock Market (“Nasdaq”) does not mandate that a listed issuer have a compensation committee, but requires that executive compensation be determined or recommended to the board for determination either by a compensation committee composed solely of independent directors or by a majority of the board’s independent directors in a vote in which only independent directors participate. Some of the other exchanges have standards comparable to the NYSE’s and require their listed issuers to have independent compensation committees. Other exchanges have standards comparable to Nasdaq’s and, in the absence of an independent compensation committee, permit executive compensation determinations to be made or recommended by a majority of independent directors on the listed issuer’s board. Proposed Rule 10C-1(b) would direct the exchanges 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.”³

I. Proposed Listing Requirements

The Proposed Rules would require the exchanges to adopt listing standards that would:

- (i) require that each member of a listed issuer’s compensation committee be a member of the board of directors and be “independent.” The term “independent” is not defined in Section 10C of the

¹ See *Listing Standards for Compensation Committees*, Release Nos. 33-9199; 34-64149; File No. S7-13-11 (March 30, 2011) (the “Proposing Release”), available at <http://www.sec.gov/rules/proposed/2011/339199.pdf>. For purposes of the Proposed Rules, a “national securities exchange” refers to an exchange registered as such under Section 6 of the Exchange Act and includes the New York Stock Exchange and the NASDAQ Stock Market among the 15 national securities exchanges presently registered with the SEC. For purposes of the Proposed Rules, a “national securities association” is an association of brokers and dealers registered as such under Section 15A of the Exchange Act. The Financial Industry Regulatory Authority (“FINRA”) is the only national securities association registered with the SEC. Because FINRA does not list equity securities, however, we refer only to the exchanges in this memorandum.

² The Dodd-Frank Act is available at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173>. Section 952 of the Dodd-Frank Act added Section 10C to the Securities Exchange Act of 1934, and the text of Section 10C is contained in Section 952 of the Dodd-Frank Act. For purposes of the Proposed Rules, the SEC has interpreted the compensation committee and other requirements in Section 10C to apply only to issuers with listed *equity* securities (emphasis added).

³ Proposing Release at 8-9.

Exchange Act (“Section 10C”). Pursuant to the Proposed Rules, the exchanges would be required to develop a definition of “independence” that would be applicable to compensation committee members. In devising the definition, the exchanges would be required to consider certain “relevant factors,” including, but not limited to:⁴

- the source of a director’s compensation, including any consulting, advisory or other compensatory fee paid by the issuer to such director.
 - whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.
- (ii) require that a listed issuer’s compensation committee:
- have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, legal counsel and other advisers (collectively, “compensation advisers”). Before a compensation committee could select a compensation adviser, however, it would be required to consider the following five independence factors (“Independence Factors”) identified by the SEC:⁵
 - (1) the provision of other services to the issuer by the compensation consulting company employing the compensation adviser;
 - (2) the amount of fees received from the issuer by the compensation consulting company that employs the compensation adviser, as a percentage of the compensation consulting company’s total revenue;
 - (3) the policies and procedures which have been adopted by the compensation consulting company employing the compensation adviser to prevent conflicts of interest;
 - (4) any business or personal relationship which the compensation adviser may have with a member of the compensation committee; and
 - (5) any stock of the issuer owned by the compensation adviser.
 - have direct responsibility for the appointment, compensation and oversight of the work of the compensation advisers. The compensation committee’s authority to retain, and its responsibility for overseeing the work of, the compensation advisers would not, however, be construed to require the compensation committee to implement or act consistently with the advice or recommendations of the compensation adviser or to affect the compensation committee’s ability or obligation to exercise its own judgment in the fulfillment of its duties.

⁴ The Proposed Rules require only that the exchanges *consider* these factors in developing independence standards for compensation committee members. This is in contrast to the language in Section 10A(m) of the Exchange Act (added by Section 301 of the Sarbanes-Oxley Act of 2002), which expressly states that the presence of these factors *precludes* independence in the case of audit committee members.

⁵ Pursuant to the Proposed Rules, the exchanges would be permitted to add other independence factors that compensation committees would be required to consider as well.

- receive adequate funding from the issuer such that the committee would be able to provide reasonable compensation to a compensation adviser.

Pursuant to the Proposed Rules, the exchanges would also be required to establish procedures for an issuer to cure any defects that would be the basis for a prohibition of the listing of its securities as a result of its failure to meet the proposed new listing requirements, before a given exchange would prohibit the listing of, or delist, any security of the issuer.

II. Exemptions From the Proposed Listing Requirements

Pursuant to the Proposed Rules, the exchanges would be required to exempt the following categories of companies from the listing requirements related to compensation committee member independence:

- Controlled companies;⁶
- Limited partnerships;⁷
- Companies in bankruptcy proceedings;⁸
- Open-end management investment companies registered under the Investment Company Act of 1940 (“Investment Company Act”);⁹ 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.¹⁰

In addition, the Proposed Rules would permit the exchanges to exempt particular relationships and categories of issuers from the compensation committee member independence requirements, taking into account such factors as the size of an issuer and any other factors that the exchanges deem relevant and appropriate.¹¹

⁶ Section 10C(g)(2) of the Exchange Act defines “controlled company” as an issuer that is listed on an exchange and holds an election for the board of directors of the issuer in which more than 50 percent of the voting power is held by an individual, a group or another issuer. Section 10C(g) specifically exempts controlled companies from all the requirements of Section 10C.

⁷ Section 10C does not define the term “limited partnerships.” In general, however, a limited partnership is a form of business ownership and association consisting of one or more general partners who are fully liable for the debts and obligations of the partnership and one or more limited partners whose liability is limited to the amount invested.

⁸ This term is not defined in Section 10C or the SEC rules.

⁹ Under the Investment Company Act, an open-end management investment company is an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer. The Proposed Rules propose to define this term by referencing Section 5(a)(1) of the Investment Company Act.

¹⁰ Exchange Act Rule 3b-4 defines “foreign private issuer” as “any foreign issuer other than a foreign government, except for an issuer that has more than 50% of its outstanding voting securities held of record by U.S. residents and any of the following: a majority of its officers and directors are citizens or residents of the United States, more than 50% of its assets are located in the United States, or its business is principally administered in the United States.”

¹¹ In determining which categories of issuers may be exempted from the requirements of Section 10C of the Exchange Act, Section 10C requires that the exchanges take into account the potential impact of the requirements of Section 10C

III. Retention of Compensation Consultants

Pursuant to Section 10C(c)(2) of the Exchange Act, the Proposed Rules would also require that, in any proxy or information statement for annual meetings of shareholders (or a special meeting in lieu of the annual meeting) at which directors are to be elected, each issuer must disclose (i) whether the compensation committee has retained or obtained the advice of a compensation consultant and (ii) whether 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.¹² The disclosure would require a description of the specific conflict and how the issuer has addressed it; a general description of the issuer's policies and procedures to address conflicts of interest would not suffice. In determining whether there is a conflict of interest that may require disclosure, the Proposed Rules also include an instruction that identifies the Independence Factors as among the factors that issuers should consider. These proposed disclosure rules regarding compensation consultants would be included by amending existing Item 407(e) of Regulation S-K and would not be subject to the exchange rulemaking process.¹³ If adopted, they would apply to all companies subject to the SEC proxy rules, whether listed or not.

IV. Timeline

The SEC is seeking public comments on the Proposed Rules through April 29, 2011, and the SEC is required by the Dodd-Frank Act to issue the final rules no later than July 16, 2011. Following publication of the final rules in the Federal Register, the exchanges will have 90 days to provide the SEC with their proposed rules, which the SEC must then approve. The exchanges are required to issue final rules within one year from the date that the final SEC rules are published in the Federal Register.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212-701-3110 or gwaldrip@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.

on smaller reporting issuers (*i.e.*, those with a public float of less than \$75 million).

¹² To provide guidance regarding whether the compensation committee or management has “obtained the advice” of a compensation consultant, the Proposed Rules propose an instruction that 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.

¹³ The disclosure trigger under Item 407(e) is currently different than under Section 10C. Under Item 407(e), the trigger is whether compensation consultants played “any role” in the registrant’s process for determining or recommending the amount or form of executive or director compensation. And, once disclosure is required, the specifics of what must be disclosed are also different under Item 407(e) and Section 10C. In addition, if adopted, the Proposed Rules would broaden the existing disclosure rules insofar as they would apply to compensation consultants who only consult on broad-based plans that are available generally to all salaried employees or who only provide non-customized information. The exemption in Item 407(e) for these consultants from certain fee disclosures would remain, however.