

SEC Proposes New Listing Standards and Disclosure Rules Related to Compensation Committees and Advisers

On March 30, 2011, the Securities and Exchange Commission (the "SEC") issued proposed rules that direct national securities exchanges to adopt certain listing standards related to compensation committees and compensation advisers of listed companies.

These listing standards would require each listed issuer to meet certain criteria related to:

- The independence of a company's compensation committee members;
- The independent authority and funding of the compensation committee; and
- The factors to be considered in selection of a compensation adviser.

The exchanges would also be required to provide by rule a reasonable opportunity for any listed company to cure its defects in compliance with compensation-related rules.

Some new disclosure requirements concerning compensation committees and consultants would also be imposed on publicly traded companies by these SEC proposals. Most notably, all public issuers would be required to disclose in proxy materials whether a compensation committee obtained the advice of a consultant and whether the consultant's work raised any potential conflicts of interest.

These rule proposals were all made pursuant to the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") which was previously summarized in our July 2010 Securities Law Update entitled "Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act," and which can be found at http://www.burnslev.com/apps/uploads/publications/Securities_Update_Dodd-Frank_July2010.pdf.

In its proposed rules, the SEC noted that the Dodd-Frank Act requires the issuance of final rules by July 16, 2011, which will direct the securities exchanges to prohibit the

listing of issuers not in compliance with the applicable compensation-related directives. Therefore, there is a narrow window for public comment on these proposals, which must be submitted by April 29, 2011.

For a full copy of these SEC rule proposals, see SEC Release nos. 33-9199, 34-64149 at <http://www.sec.gov/rules/proposed/2011/33-9199.pdf>.

LEGISLATIVE BACKGROUND

The proposed rules are necessitated by the provisions of Section 952 of the Dodd-Frank Act, which adds Section 10C to the Securities Exchange Act of 1934 (the "Exchange Act"). This section requires the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that is not in compliance with the compensation committee and adviser requirements of the Dodd-Frank Act.

Those requirements explicitly state that each compensation committee of an exchange-listed company must, at a minimum:

- Have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers;
- Before selecting any compensation adviser, take into consideration specific factors identified by the SEC that affect adviser independence;
- Be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser; and
- Have available from the issuer appropriate funding for the payment of reasonable fees, as determined by the committee, to compensation advisers.

INDEPENDENCE STANDARDS FOR COMPENSATION COMMITTEE MEMBERS

Proposed Rule 10C-1(b) would require each

member of a listed issuer's compensation committee to be independent under a definition of independence to be developed by the exchanges. The definition would be required to address all relevant factors, including at a minimum:

- The impact of the sources of a director's compensation, including consulting or advisory fees; and
- The impact of whether the director is affiliated with an issuer or one of its affiliates.

This approach, said the SEC, will give exchanges some discretion to determine their own minimum "independence" standards in light of relevant criteria, including criteria they might add on their own.

According to the SEC, it is possible and acceptable for the exchanges to determine that certain affiliations are not destructive of independence. The exchanges could determine, for instance, that even though affiliated directors are not allowed to serve on audit committees pursuant to Sarbanes-Oxley rules, that such a blanket prohibition would be inappropriate for compensation committee members.

AUTHORITY AND FUNDING TO RETAIN COMPENSATION ADVISERS

Proposed Rule 10C-1(b)(2) would codify into regulation the Dodd-Frank Act mandate that: (1) the compensation committee be given authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers; and (2) the compensation committee be responsible for the appointment, compensation and oversight of the work of any compensation adviser.

Under proposed Rule 10C-1(b)(3) listed issuers would also have to comply with the Dodd-Frank mandate to provide for appropriate funding for payment of reasonable sums to competent compensation advisers.

INDEPENDENCE FACTORS FOR COMPENSATION ADVISERS

The SEC noted that Section 10C of the Exchange Act does not require hired compensation advisers to be independent, unlike compensation committee members. The statute only requires that the compensation committee consider factors that may bear upon independence, including:

- The provision of other services to the issuer by the employer of the compensation consultant, legal counsel or adviser;
- The amount of fees received from the issuer by the employer of the compensation consultant, counsel or adviser, as a percentage of their employer's total revenue;
- The policies and procedures of the employer of the compensation consultant, legal counsel or adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation consultant, counsel or adviser with a member of the compensation committee; and
- Any stock of the issuer owned by the compensation consultant, legal counsel or other adviser.

Thus, proposed Rule 10C-1(b)(4) would require the exchanges to adopt listing standards that mandate consideration of these independence factors while allowing the exchanges to add other independence factors that may be considered by the compensation committees of listed issuers.

OPPORTUNITY TO CURE DEFECTS

Proposed Rule 10C-1(a)(3) would require the national exchanges to establish procedures allowing reasonable opportunity for an issuer to cure any defects that could form the basis for de-listing of the issuer's securities or prohibition of their sale, prior to such de-listing or prohibition.

In addition, the SEC offered a proposed Rule 10C-1(a)(3), which would allow the exchanges to provide by rule that if a member of a compensation committee ceases to be independent for reasons outside of the member's control, then 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 or the listed issuer or one year from the occurrence of the disqualifying event.

APPLICATION OF LISTING REQUIREMENTS

The new listing requirements concerning compensation-related rules would not apply to all securities or issuers, or all exchanges. The SEC provided for some limited exemptions from compliance, including the following:

1. Affected Securities/Issuers

Section 10C of the Exchange Act specifies in one subsection that the compensation committee listing requirements should apply to issuers with listed "equity securities" but in another subsection suggests that the requirements apply to issuers with any listed securities.

Based on a review of legislative history, the SEC decided to issue a tentative interpretation that the listing requirements in question would not apply to debt securities, which are already exempted from most proxy and information statement requirements under Exchange Act Rule 3a12-11.

In addition, the SEC also noted that the Commodity Futures Modernization Act of 2000 permits national exchanges to trade futures on individual securities and security indices without such securities being subject to registration under the Securities Act of 1933 (the "Securities Act"). Thus, the SEC proposed to exempt security futures products or issuers that deal only in securities futures from compliance with Rule 10C-1.

2. Exemptions from Independence Requirements

Because the exchanges will be permitted to propose exemptions to the listing standards required by Section 10C of the Exchange Act, the SEC decided not to propose any exemptions beyond the five categories specified by the Dodd-Frank Act; however, the SEC did note that the exchanges are required by Section 10C to take into account the potential impact of any listing requirements on smaller reporting issuers.

The five categories of issuers not subject to an exchange's compensation committee independence requirements under proposed Rule 10C-1(b)(1)(iii) are as follows:

- Any controlled company, which is defined by Section 10C(g)(2) of the

Exchange Act to be any issuer which is holding an election for the board of directors in which more than 50 percent of the voting power will be held by an individual, a group or another issuer;

- Any limited partnership 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 partnership exposure is limited to the amount invested;
- Any company that is in bankruptcy proceedings (with no definitions or limits as to the type of proceedings);
- Any open-end management investment company, which is defined in the Investment Company Act of 1940 as an investment company, other than a unit investment trust or face-amount certificate company, which offers for sale or has outstanding any redeemable security which it has issued; and
- Any foreign private issuer that provides annual full disclosure to shareholders of the reasons why the issuer does not have an independent compensation committee.

The SEC also proposed Rule 10C-1(b)(1)(iii) (B), which would authorize national exchanges to provide for additional rational exemptions related to particular relationships between members of the compensation committee and listed issuers that might otherwise impair a member's independence.

DISCLOSURES ABOUT COMPENSATION CONSULTANTS AND CONFLICTS

The SEC proposed to combine the current compensation-related disclosure requirements of Item 407(e) of Regulation S-K with the requirements of Section 10C(c)(2) of the Exchange Act to form one disclosure requirement that would apply to Exchange Act registrants, whether listed or not, and whether they are controlled companies or not.

Item 407(e)(3)(iii) disclosure requirements already direct registrants to disclose "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation." They also require registrants to:

- Identify the consultants;

- State whether the consultants were engaged directly by the compensation committee or any other person;
- Describe the nature and scope of the consultants' assignments, and the material elements of any instructions given to the consultants under the engagement; and
- List the aggregate fees paid to a consultant for advice or recommendations on the amount or form of executive and director compensation, and the aggregate fees for additional services the consultant provided in excess of \$120,000 during the fiscal year.

The new requirements of Section 10C(c)(2) would be layered into a new, all-encompassing disclosure rule, which would additionally direct each issuer to disclose:

- 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, how that conflict is being addressed.

But the new compensation and conflict of interest disclosures would be required "only for proxy and information statements for annual meetings, or a special meeting in lieu of an annual meeting, at which directors are to be elected," according to the SEC's proposal.

Also, under revised Item 407(e)(3)(iii), disclosure of whether the compensation committee obtained or retained the advice of a compensation consultant during the registrant's last completed fiscal year, and whether the consultant's work raised any conflict of interest would be required even if the consultant provides only advice on broad-based plans or provides only non-customized benchmark data (a broadening of the scope of the current rule).

The SEC proposed some clarifying instructions to this rule as well. The first would provide that the phrase "obtained advice" relates to whether a compensation committee or management has requested advice from a compensation consultant, regardless of whether there is a formal engagement of the consultant or any payment of fees for consulting advice.

A second clarifying instruction would identify the five factors used in determining the independence of a compensation adviser in Rule 10C-1(b)(4) as being among the factors that issuers should consider in determining whether the work of a consultant has raised a conflict of interest.

Under the proposed disclosure rule, if a compensation committee did determine there was a conflict of interest with a compensation consultant, then the issuer would be required to provide a clear and concise description of the conflict and how the issuer has dealt with it.

TRANSITION AND TIMING ISSUES

The SEC proposed that each exchange should provide their proposed compensation-related rules for approval within 90 days after publication of the SEC proposals in the Federal Register. Each exchange would also have to obtain SEC approval of final rules no later than one year after such publication.

While the Dodd-Frank Act requires affected public companies to make new compensation-related disclosures by July 21, 2011, the SEC noted that its regulations do not yet require such disclosures, and thus no such disclosures will be required before the effective date of any final rules on this subject.

Explanatory Notes:

This update is intended to call your attention to a number of rule changes of possible interest and relevance, but it is not intended to constitute a legal opinion or definitive summary of all changes that could be material to you.

Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these potential rule changes or if you want to learn more about our expertise in this area.

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THE SECURITIES LAW GROUP

Josef Volman - Co-Chair
617.345.3895 | jvolman@burnslev.com

Andrew Merken - Co-Chair
617.345.3740 | amerken@burnslev.com

If you have any questions regarding this Burns & Levinson Securities Law Update, please contact one of the individuals named above.

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