

July 2, 2012

SEC Adopts Final Rule Requiring Exchanges to Establish Listing Standards Regarding Independence of Compensation Committees and Compensation Advisers

On June 20, the Securities and Exchange Commission adopted a final rule, pursuant to Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, concerning the independence of board compensation committees and compensation consultants. The Dodd-Frank Act added Section 10C to the Securities Exchange Act of 1934, which requires the SEC to direct national securities exchanges to prohibit the listing of any equity security of an issuer that does not comply with Section 10C's compensation committee and compensation adviser independence requirements. Controlled companies and smaller reporting companies are exempt from the requirements of these listing standards, and certain other specified issuers are exempt from the compensation committee independence requirements.

Under new Rule 10C-1, national securities exchanges must adopt listing standards with the following requirements:

- Each member of an issuer's compensation committee must be a member of the board of directors and must be independent as defined under the existing standards.
- If a compensation committee (at its sole discretion) retains or obtains the advice of a compensation adviser, it is directly responsible for the appointment, payment and oversight of that adviser.
- A compensation committee may select a compensation adviser only after considering specified independence factors.

In addition, the SEC amended Item 407 of Regulation S-K to require each public company subject to the proxy rules (whether listed or not) to disclose, in its proxy statement, whether the work of a compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Click [here](#) for the Final Rule Release Nos. 33-9330 and 34-67220.

Effective Dates

Rule 10C-1 and the Item 407 amendment are effective on July 27, 2012. Each national securities exchange must provide to the SEC proposed rules or rule amendments that comply with the new rule by September 25, 2012. Each exchange must have final listing rules or rule amendments approved by the SEC by June 27, 2013. Issuers must comply with amendments to Item 407 of Regulation S-K for proxy statements for meetings on or after January 1, 2013, at which directors are elected.

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Requirements for Compensation Committee Members

The new rule directs the national securities exchanges to establish listing standards that require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent." The rule directs the exchanges to develop a definition of independence applicable to compensation committee members after considering relevant factors, including, but not limited to, the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the issuer to such director, and whether the director is affiliated with the issuer or an affiliate of the issuer.

The SEC does not define the term "affiliate" for purposes of the rule. Although each exchange must consider the affiliate relationships specified in the rule in establishing standards for the independence of compensation committee members, the exchange is not required to adopt listing standards precluding compensation committee membership based on such a relationship.

Under the rule, the exchanges are directed to apply such listing standards 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," as well as, with certain limited exceptions, the members of the board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of an applicable board committee.

Authority to Retain Compensation Advisers

The rule provides that the compensation committee of a listed issuer may, at the sole discretion of the committee, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser (collectively, "compensation advisers"). The rule also provides that compensation committees will be directly responsible for the appointment, compensation and oversight of the work of compensation advisers. Under the rule, compensation committees are not required to implement or act consistently with the advice or recommendations of a compensation adviser, and compensation committees must exercise their own judgment in fulfillment of their duties.

The rule requires listed issuers to provide appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to compensation advisers.

Independence of Compensation Advisers

The rule provides that the exchanges require that a compensation committee may select a compensation adviser only after taking into consideration the following six independence factors:

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

Under the rules, the exchanges may add other independence factors that compensation committees must consider. The rules do not require a compensation adviser to be independent. Instead, the compensation committee must only consider the enumerated independence factors before selecting a compensation adviser. The compensation committee is not required to consider these factors when it receives advice from in-house counsel.

Opportunity to Cure Defects

Under the rule, exchanges must establish appropriate procedures (to the extent their existing procedures are inadequate) for an issuer to have a reasonable opportunity to cure any defects as a result of the issuer's failure to meet the requirements set forth in the rules, before prohibiting the listing of, or delisting, such issuer's securities.

Exemptions

The new rule specifically exempts controlled companies and smaller reporting companies from all of the requirements of the new listing standards.

In addition, an issuer in any of the following categories cannot be delisted for not complying with an exchange's compensation committee independence requirements:

- 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.

The rule authorizes 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.

Disclosure of Compensation Consultants and Conflicts of Interest

Existing Item 407(e)(3)(iii) of Regulation S-K currently requires Exchange Act registrants subject to the proxy rules to disclose in any proxy or consent solicitation material for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) if their compensation committee has retained or obtained the advice of a compensation consultant. The amendments to Item 407(e)(3) require further disclosure as to whether the work of the disclosed compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. The six independence factors set forth in the new rule described above are among the factors that should be considered in determining whether a conflict of interest exists. These disclosure requirements apply to Exchange Act registrants subject to the proxy rules, regardless of whether they have equity listed on a national exchange, and only apply to compensation consultants (as opposed to the broader category of "compensation advisers" used in the rule, which includes legal counsel or other advisers).

Compliance Considerations

Final exchange listing rules regarding compensation committees and compensation advisers will likely be effective for the 2013 proxy season. As such, companies with equity securities listed on a national securities exchange should reevaluate the independence of their compensation committee members and the committee's compensation advisers in light of the factors set forth in the rule. Issuers and their compensation committees should consider procedures for identifying and reviewing any relationships between issuers and their compensation committee members and the committee's compensation advisers. While the rule should not result in significant governance changes for NYSE and Nasdaq listed issuers, issuers should nonetheless confirm that they will not need to modify the membership of their compensation committees. Because of the required consideration of the independence factors for the compensation committee's advisers, companies will need to review the information that is gathered in connection with their procedures for retaining the committee's compensation advisers, in order to comply with the provisions of the listing rules, when adopted. In-house counsel (which will not be subject to the independence requirements of the new listing standards) and management's outside legal counsel (subject to consideration of the independence factors) can continue to advise the compensation committee in connection with these matters as compensation advisers are not required to be independent. In addition, public companies subject to the proxy rules (including

companies that do not have equity securities listed on a national securities exchange) should be prepared to make inquiries of their compensation consultants to identify possible conflicts and, where relevant, add additional disclosure in next year's proxy statements concerning any conflicts of interest and how the conflict is being addressed.

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