HINSHAW
& CULBERTSON LLP

Corporate / Financial Institutions ALERT

Listing Standards for Compensation Committees

July 19, 2012

As required by the Dodd-Frank Act, the U.S. Securities and Exchange Commission (SEC) has adopted final rules directing national securities exchanges ("the Exchanges") to adopt listing standards relating to director independence standards for compensation committee members, the selection of compensation committee advisers, and conflicts of interest related to such advisers. These rules implement Section 10C of the Securities Exchange Act of 1934 ("the Exchange Act"). They became effective on July 27, 2012; the Exchanges must adopt listing standards by September 25, 2012.

Under the SEC's rules, each issuer must disclose in any proxy or consent solicitation material for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) whether the issuer's compensation committee retained or obtained the advice of a compensation consultant. Issuers will now have to disclose whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Compensation Committee

The listing standards will apply to any board committee that performs functions typically performed by a compensation committee, including oversight of executive compensation, regardless of whether the committee also performs other functions or is formally designated as a compensation committee.

Furthermore, the term "compensation committee" includes, for most purposes, the members of the board of directors who oversee executive compensation matters on behalf of the board in the absence of a formal committee.

The SEC's final rule does not require an issuer to have a compensation committee or a committee that performs functions typically assigned to a compensation committee. However, the Exchanges are permitted to adopt rules which require issuers to maintain a compensation committee.

Director Independence Requirements

Members of the compensation committee must be independent. Directors who oversee executive compensation matters on behalf of the board in the absence of a committee must also be independent. In setting the independence requirements, the Exchanges must consider all relevant factors, including, but not limited to, the two set forth in Section 10C of the Exchange Act:

The source of compensation of a member of the board of directors of an issuer, including any consulting advisory or other compensatory fee paid by the issuer; and

Whether a compensation committee member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The SEC did not instruct the Exchanges to consider any additional factors when determining independence requirements for members of compensation committees. Furthermore, the final rule does not prescribe any standards or relationships that will automatically preclude a finding of independence nor does it impose any required look-back periods that must be incorporated in the independence standards.

Exemptions from Independence Requirements

The listing of equity securities of the following categories of issuers is not subject to the director independence requirements:

- 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 Exchanges may exempt a particular relationship with respect to members of the compensation committee from the independence requirements, as an Exchange determines is appropriate, taking into consideration the size of an issuer and other relevant factors.

Authority to Retain Compensation Advisers; Responsibilities; and Funding

Under the final rules, the Exchanges must adopt listing standards that provide that:

- The compensation committee has the sole authority to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers;
- The compensation committee, including directors who oversee executive compensation matters in the absence of a board committee, are directly responsible for the appointment, compensation and oversight of the work of any compensation adviser retained by the committee; and
- The issuer must provide appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the advisers.

The responsibility to oversee such advisers applies only to those advisers retained by a compensation committee and not advisers engaged by management.

The final rule requires the payment of reasonable compensation not only to independent legal counsel but also to “any other adviser” to the compensation committee, which includes any compensation

advisers retained by the committee, such as attorneys and consultants, whether or not they are independent.

The committee, however, does not have to implement or act consistently with the advice or recommendations of any adviser. A compensation committee is free to exercise its own judgment in fulfillment of its duties.

The compensation committee may receive advice from nonindependent counsel, such as in-house counsel or outside counsel retained by management, or from a nonindependent adviser, including those engaged by management.

Opportunity to Cure Defects

The Exchanges must provide reasonable opportunity to cure any noncompliance with the compensation committee listing requirements that could result in the delisting of an issuer's securities. If a member of a listed issuer's compensation committee ceases to be independent for reasons outside the member's reasonable control, that person, with notice to the applicable Exchange, may remain a compensation committee member until the earlier of the next annual shareholders' meeting or one year from the occurrence of the event that caused the member to be no longer independent. The Exchanges may provide issuers opportunities to cure other defects.

Compensation Adviser Conflicts of Interest

Under the final rule, the compensation committee (including members of an issuer's board who oversee executive compensation matters) may select a compensation adviser (other than in-house counsel) to the compensation committee only after taking into consideration the six factors listed below, as well as any other factors identified by the Exchanges:

- Other services provided by the employer of the compensation adviser;
- Fees received from the issuer by the employer of the compensation adviser, as a percentage of the total revenue of such employer;
- The conflicts of interest policies and procedures of the adviser's employer;
- Any business or personal relationship of the compensation adviser with a member of the compensation committee;
- Any of the issuer's stock owned by the compensation adviser; and
- Any business or personal relationship of the compensation adviser or the adviser's firm with an executive officer of the issuer.

The final rule does not include any materiality, numerical or other thresholds which a compensation committee is required to consider other than the independence factors specified above.

A compensation adviser does not have to be independent. A committee may select any compensation adviser it prefers, including one that is not independent, after considering the six independence factors outlined in the final rule.

An issuer does not have to describe the committee's process for selecting its advisers.

Compensation Consultant Disclosure and Conflicts of Interest

Under Item 407(e)(3)(iii) of Regulation S-K, registrants are currently required to disclose "any role of compensation consultants in determining or recommending the amount or form of executive and director compensation." Specifically, registrants are required to:

- Identify the consultants;
- State whether such consultants were engaged directly by the compensation committee or any other person;
- Describe the nature and scope of the consultant's assignment and the material elements of any instructions given to the consultants under the engagement; and
- Disclose 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 if the consultant provided both and the fees for the additional services exceeded $120,000 during the fiscal year.

Under new Item 407(e)(3)(iv), if the work of a compensation consultant identified in response to Item 407(e)(3)(iii) has raised a conflict of interest, the issuer must disclose the nature of the conflict and how the conflict is being addressed.

For purposes of Item 407(e)(3)(iii), the factors listed above (Compensation Adviser Conflicts of Interest) are among the factors that should be considered in determining whether a conflict of interest exists.

With respect to the new requirement to disclose compensation consultant conflicts of interest, the rule applies to any compensation consultant whose work must be disclosed pursuant to Item 407(e)(3)(iii), regardless of whether the consultant was retained by management or the compensation committee or any other board committee.

Issuers will be required to comply with the new disclosure requirement relating to compensation consultant conflicts of interest in a proxy or information statement for an annual meeting (or special meeting in lieu of an annual meeting) at which directors are to be elected.

This new subparagraph will apply to issuers subject to the SEC's proxy rules, including controlled companies, nonlisted issuers and smaller reporting companies.

The final rule does not require disclosure of potential conflicts of interest or an appearance of a conflict of interest, nor does it require disclosure with respect to compensation advisers other than compensation consultants.

Item 407(e)(3) will continue to exempt consulting on broad-based plans and providing noncustomized benchmark data from the compensation consultant disclosure requirements under Item 407(e)(3), as well as the required conflicts of interest disclosure.

Disclosure Regarding Director Compensation

Issuers are currently required to discuss in proxy and information statements the role played by compensation consultants in determining or recommending the amount or form of director compensation to the same extent that the disclosure is required regarding executive compensation. To the extent such consulting raises a conflict of interest on the part of the compensation consultant, disclosure would be required in response to new Item 407(e)(3)(iv).

Exemptions

Under the rules, exemptions from all of the listing standards will be available for:

- Smaller reporting companies (generally defined as having a public float of less than $75 million);
- Controlled companies (in which 50 percent of the voting power for the election of directors is held by an individual, a group or another company); and
- Issuers that only issue debt securities.

When an issuer loses its smaller-reporting-company status, it will be required to comply with the listing standards applicable to non-smaller-reporting companies. The Exchanges should provide for a transition period for issuers that lose smaller-reporting-company status, similar to what they currently have for issuers that lose controlled company status.

Emerging Growth Companies

The Jumpstart Our Business Startups Act (the JOBS Act) created a new category of issuer, an “emerging growth company.” An emerging growth company is defined as an issuer that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. The rules will permit the Exchanges to consider whether any exemptions from the listing standards required by Rule 10C-1 are appropriate for emerging growth companies or any other category of issuer.

Transition

Each Exchange must provide proposed listing rules or rule amendments that comply with the final rule to the SEC by September 25, 2012. Each Exchange would need to adopt final rule or rule amendments that comply with the SEC’s final rule no later than July 27, 2013.

Although the final rule does not provide an extended transition period for newly listed issuers, the exemptive authority provided to the Exchanges under the final rule permits them to propose appropriate transition periods.

Compliance with new Item 407(e)(3)(iv) will be required in any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013.

For further information, please contact Tim Sullivan or your regular Hinshaw attorney.
