INVESTMENT COMPANY INSTITUTE

MEMO# 26253

June 21, 2012

SEC Adopts Listing Standards for Compensation Committees

[26253]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 35-12
ETF ADVISORY COMMITTEE No. 19-12
SEC RULES MEMBERS No. 54-12 RE: SEC ADOPTS LISTING STANDARDS FOR COMPENSATION COMMITTEES

On June 20, 2012, the Securities and Exchange Commission ("SEC") adopted a new rule and rule amendments to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). [1] This provision of the Dodd-Frank Act, which added Section 10C to the Securities Exchange Act of 1934, 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 Section 10C's compensation committee and compensation adviser requirements.

To implement Section 10C, the SEC adopted new Rule 10C-1, which directs the national securities exchanges to establish listing standards that, among other things, require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent" as defined in the listing standards. In addition, the SEC adopted amendments to the proxy disclosure rules in Regulation S-K concerning the use of compensation consultants and related conflicts of interest. The final rules do not require a listed issuer to have a compensation committee or a committee that performs functions typically assigned to a compensation committee. Nor do the new rules require issuers to hire compensation advisers or to retain or obtain advice only from independent compensation advisers. Because most registered investment companies do not have compensated employees, the requirements regarding compensation committees will not affect most registered investment companies. Moreover, the SEC's proxy disclosure rules in Regulation S-K do not apply to registered investment companies.

Each national securities exchange and national securities association must submit to the SEC proposed rule changes to comply with the new requirements no later than 90 days after publication in the Federal Register of the new rules and must have final rules approved by the SEC one year after publication of these new rules in the Federal Register. Issuers must comply with the disclosure changes in Regulation S-K in any proxy or information statement for an annual meeting at which directors will be elected on or after

January 1, 2013. A summary of the final rules is provided below.

Applicability of Exchange Listing Standards and Independence Requirements

Under Rule 10C-1(b), the exchanges are directed to adopt listing standards that apply to a compensation committee and to any committee of the board that performs functions typically performed by a compensation committee, including oversight of executive compensation, whether or not such committee also performs other functions or is formally designated as a compensation committee. The SEC generally defines the term "compensation committee" also to include members of the board of directors who oversee executive compensation matters on behalf of the board in the absence of a formal committee.

Under Rule 10C-1(b)(1), the exchanges are directed to establish listing standards requiring each member of a listed issuer's compensation committee to be a member of the board of directors and be independent. In developing their own definitions of independence, the exchanges must consider certain relevant factors.

Compensation Advisers and Independence Factors

Under Rule 10C-1(b)(2), the exchanges are directed to adopt listing standards that provide that the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation adviser and the compensation committee shall be directly responsible for the appointment, compensation, and oversight of the work of any compensation adviser retained by the compensation committee. Moreover, each listed issuer must provide for appropriate funding for payment of reasonable compensation, as determined by the compensation committee, to any compensation adviser retained by the committee.

Under Rule 10C-1(b)(4), the exchanges are directed to adopt listing standards that require the compensation committee to take into account certain independence factors before selecting a compensation adviser. These factors include the five factors enumerated in Section 10C(b)(2) as well as any business or personal relationships between the executive officers of the issuer and the compensation adviser or the person employing the adviser. Compensation committees, however, may select any compensation adviser they prefer, including ones that are not independent, after considering the six independence factors.

Opportunity to Cure Defects

Under Rule 10C-1(a)(3), the exchanges are required to provide appropriate procedures for listed issuers to have a reasonable opportunity to cure any noncompliance with the compensation committee listing requirements that could result in the delisting of an issuer's securities.

Implementation of Listing Requirements

In the final rules, the SEC requires that the exchange listing standards only need to apply to issuers with listed equity securities and exempts security futures products cleared by a clearing agency and standardized options that are issued by a clearing agency.

In addition, the SEC exempts from the compensation committee member independence listing standards certain entities, including registered open-end management investment companies, listed in Section 10C(a)(1) and exempts from the required standards any controlled company and smaller reporting companies. The SEC determined not to exempt other types of investment companies, including closed-end investment companies and unit investment trusts. With respect to these other investment companies, the SEC states that the exchanges are in a better position to determine the appropriate treatment of these investment companies that may have compensated executives and compensation committees. [2]

Compensation Consultant Disclosure and Conflicts of Interest

In new Item 407(e)(3)(iv) of Regulation S-K, the SEC requires each issuer to disclose for any compensation consultant with a role in determining or recommending the amount or form of executive and director compensation whether the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. [3] As noted by the SEC, Item 407(e) does not apply to registered investment companies. [4]

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endnotes

[1] Listing Standards for Compensation Committees, Release Nos. 33-9330; 34-67220 (June 20, 2012), available at http://www.sec.gov/rules/final/2012/33-9330.pdf ("Adopting Release").

[2] New Rule 10C-1(b)(5) permits the national securities exchanges and national securities associations to exempt from the requirements of the section certain categories of issuers as the national securities exchange or national securities association determines is appropriate.

[3] Item 407 of Regulation S-K requires registrants under the Securities Exchange Act of 1934 that are subject to the proxy rules, other than registered investment companies, to provide certain disclosure concerning their compensation committees and the use of compensation consultants.

[4] See Adopting Release, supra note 1, at n. 236.