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How Foreign Private Issuers are Likely to be Affected by New Listing Standards for Compensation Committees

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") directed the U.S. Securities and Exchange Commission (the "SEC") to establish minimum standards that companies listed in the United States would have to meet in setting executive compensation. Rather than adopting rules with direct effect on issuers, the SEC would be adopting rules requiring U.S. stock exchanges to amend their listing standards, as the SEC was directed to do in 2002 under the Sarbanes-Oxley Act (the "Sarbanes-Oxley Act") in respect of a range of other corporate governance matters.

On June 20, the SEC issued new rules directing U.S. stock exchanges to prohibit via their listing standards the listing of any equity security of a company that is not in compliance with the Dodd-Frank provisions governing the composition of compensation committees; compensation committee responsibilities and advisors; and disclosure regarding compensation consultants. These new rules provide for specific exemptions and grant the U.S. stock exchanges discretion to exempt categories of issuers from other aspects of the standards.

As was the case with the Sarbanes-Oxley Act's directive to the SEC to establish listing standards governing audit committee membership, the key question for foreign private issuers[1] has been how the new standards governing compensation committees would affect them, given the general approach in the United States of allowing non-U.S. companies to look to home country rules for governance matters. The SEC has now given a partial answer:

- Foreign private issuers that provide annual disclosures to shareholders of the reasons why they do not have an independent compensation committee will be exempt from the requirement to have an independent compensation committee.

- However, it is unclear whether an exemption will be made available with respect to the requirements related to compensation committee responsibilities and advisors.

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[1] A foreign private issuer is a company organized outside the United States (other than a foreign government) so long as it does not fail to meet both prongs of a two-part test. If the company fails to meet both prongs of the test, it ceases to be a "foreign private issuer." Part one of the test calls for a determination of whether more than 50% of the company's voting securities are held, directly or indirectly, of record by U.S. residents. If more than 50% of the voting securities are so held, the company must evaluate the second prong and determine if (a) a majority of its executive officers or directors are U.S. residents or U.S. citizens, (b) a majority of its assets are located in the United States or (c) the company's business is principally administered from the United States. If any of these three apply to the company, company will not be a "foreign private issuer."

The U.S. stock exchanges have discretion to exempt certain categories of issuers from these rules, as they deem appropriate.

- The SEC also amended the U.S. proxy rules to require companies to disclose with respect to any compensation consultants that had a role in determining or recommending the amount or form of executive and director compensation (with certain exceptions) whether that consultant's work raised any conflicts of interest and if so, the nature of such conflict and how it was addressed. The U.S. proxy rules generally do not apply to foreign private issuers.

New Section 10C of the Securities Exchange Act

The Dodd-Frank Act added a new Section 10C to the Securities Exchange Act of 1934. As required, the SEC promulgated rules directing the national securities exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C's compensation committee and compensation advisor requirements. The rules require the U.S. stock exchanges' listing standards to address the independence of the members of a compensation committee and the retention, oversight over and independence of any compensation advisors.

The SEC decided not to require listed companies to have a compensation committee, and the new rules will apply whether or not listed issuers have a compensation committee. The rules will apply 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. In the absence of a compensation committee, the rules will apply to those members of the board of directors who oversee executive compensation matters on behalf of the board of directors, with the exception of the rules providing for a compensation committee's authority to retain compensation advisors and the required funding for payment to such advisors. That is because the SEC believes that, in the absence of a formal committee structure, the directors retain all the powers of the board of directors and, therefore, these provisions would be unnecessary in such situations. In the case of foreign private issuers with two-tier boards of directors, the rules will apply to the supervisory or non-management board.

These new rules, as applicable to domestic registrants, are discussed in detail in our companion memorandum entitled "SEC Issues Final Compensation Committee Rules."

The U.S. stock exchanges are required to implement the new listing standards within one year from the date of publication of the new SEC rules in the *Federal Register*.

Impact on Foreign Private Issuers

Foreign private issuers that disclose in their annual reports the reasons why they do not have an independent compensation committee will be exempt from the requirement to have an independent compensation committee. Assuming that a foreign private issuer does not prepare a proxy statement that complies with the U.S. proxy rules, it will also not be required to provide disclosure regarding conflicts of interest involving compensation consultants.

The U.S. stock exchanges must issue listing standards requiring that compensation committees be authorized to retain or obtain the advice of compensation consultants, independent legal counsel and other compensation advisors. Compensation committees must be directly responsible for the appointment, compensation and oversight of the work of these advisors and must be appropriately funded to retain and pay these advisors. Foreign private issuers may be subject to these requirements unless they are "controlled companies," that is companies where more than 50% of their voting power for the election of directors is held by a single individual, group or another company. We say "may" as the U.S. stock exchanges have the discretion to exclude other classes of issuers, which could include foreign private issuers.

If foreign private issuers are subject to these provisions, then when engaging, or receiving advice from, advisors (other than in-house counsel), their compensation committees must do so only after consideration of six specified factors, as set forth below, and any others that the relevant U.S. stock exchange may adopt:

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

The SEC is not mandating that compensation advisors be independent, only that compensation committees consider these independence factors when making the appointment or receiving advice.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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