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COUNSELORS AT LAW
PUBLIC COMPANIES AND CAPITAL FORMATION GROUP

SEC NEWS

JUNE / JULY 2012 NUMBER SIX

New Compensation Committee Regime

WHAT HAS CHANGED IN COMPENSATION COMMITTEE REQUIREMENTS AND DISCLOSURES AFTER THE ISSUANCE OF THE NEW SEC RELEASE?

The SEC's adoption of a new Rule 10C-1, *Listing Standards Relating to Compensation Committees,* moves us one step closer to having the mandate of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) fully implemented and to securities exchanges adopting listing standards relating to the independence of the compensation committee members and compensation advisers that provide advice to the compensation committee, the committee's authority to retain compensation advisers, and the committee's responsibility for the appointment, compensation and oversight of the work of a compensation adviser. Each national securities exchange must provide to the SEC proposed rules that comply with Rule 10C-1 no later than September 25, 2012, and must have final rules that comply with Rule 10C-1 no later than June 27, 2013.

Public companies will also have to comply with a new disclosure requirement related to the conflicts of interest of compensation consultants in any proxy or information statement for a meeting of shareholders at which directors will be elected occurring on or after January 1, 2013. Pursuant to this new requirement under Item 407(e)(3)(iv) of Regulation S-K, public companies will have to disclose the nature of the conflict of interest, if any, related to the compensation consultant's work on executive and director compensation and how the conflict is being addressed. This disclosure requirement applies where the work of a compensation consultant hired by the compensation committee or management (provided the compensation committee did not hire its own compensation consultant) to determine or recommend the amount or form of executive and director compensation (excluding consulting on broad-based plans and providing non-customized benchmark data) raises any conflict of interest.

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New Compensation Committee Regime (continued)

To evaluate whether the conflict of interest exists, the company should consider, at a minimum, the following factors:

- the provision of other services to the company by the entity that employs the compensation consultant;
- the amount of fees received from the company by the entity that employs the compensation consultant as a percentage of the total revenue of such entity;
- the policies and procedures of the entity that employs the compensation consultant that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant with a member of the compensation committee;
- any stock of the company owned by the compensation consultant; and
- any business or personal relationship of the compensation consultant or the entity employing the compensation consultant with an executive officer of the company.

WHAT SHOULD WE DO NOW?

In addition to monitoring the rulemaking of national securities exchanges related to the implementation of Rule 10C-1 directives, public companies should consider taking the following actions in connection with the required analysis of the conflicts of interest related to the work of a compensation consultant:

- establish procedures for obtaining information about (i) all services provided to the company by the compensation consultant and the entity that employs the consultant during the last completed fiscal year and any interim period of the current fiscal year, (ii) the amount of fees received from the company by the entity that employs the compensation consultant as a percentage of the total revenue of such entity, and (iii) any stock of the company owned by the compensation consultant;
- request and review the policies and procedures of the entity that employs the compensation consultant that are designed to prevent conflicts of interest; and
- update directors' and officers' questionnaires to include questions related to the business or personal relationships of (i) the compensation consultant with a member of the compensation committee; and (ii) the compensation consultant, or the entity employing the compensation consultant, with an executive officer of the company. ■ Return to Table of Contents

SEC to Consider Dodd-Frank Act and JOBS Act Rulemaking in August 2012

The SEC announced that on August 22, 2012 at 10:00 a.m. it will hold an open meeting to consider:

- whether to adopt rules regarding disclosure and reporting obligations with respect to the use of conflict minerals to implement the requirements of Section 1502 of the Dodd-Frank Act;
- whether to adopt rules regarding disclosure and reporting obligations with respect to payments to governments made by resource extraction issuers to implement the requirements of Section 1504 of the Dodd-Frank Act; and
- rules to eliminate the prohibition against general solicitation and general advertising in securities offerings conducted pursuant to Rule 506 of Regulation D under the Securities Act of 1933, as amended, and Rule 144A promulgated thereunder as mandated by Section 201(a) of the Jumpstart Our Business Startups Act (JOBS Act). ■ Return to Table of Contents

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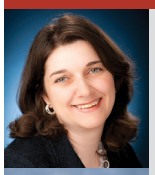

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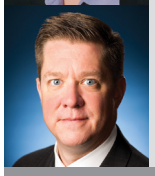

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SEC Approves FINRA Rule Relating to Filing of Private Placements

Recently, the SEC approved, on an accelerated basis, FINRA Rule 5123 (the Rule). The Rule will require, subject to certain exceptions, FINRA member firms that sell securities in certain private placements to submit a notice filing with FINRA. FINRA has noted that the filing requirement is a notice filing only. Therefore, issuers and member firms should not expect to receive FINRA comments or input before commencing an offering.

Under the Rule, members that sell a security in a private placement must submit to FINRA a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions thereof, used in connection with such sale. Submissions must be made within 15 calendar days of the first sale. Members that do not employ offering documents must indicate to FINRA that no such documents were used in connection with the applicable offering.

The rule exempts certain offerings and offerings to certain purchasers from the notice filing requirements. For example, offerings made solely to one or more of the following purchasers are exempt: institutional accounts, qualified purchasers, qualified institutional buyers (QIBs), investment companies, entities composed exclusively of QIBs, banks, employees and affiliates of the issuer, knowledgeable employees, eligible contract participants, and accredited investors as defined in Securities Act Rule 501(a)(1), (2), (3) or (7).

Exemptions based on the type of offering include: offerings made pursuant to Securities Act Rule 144A or Regulation S, offerings of certain short-term debt securities, offerings of subordinated loans, offerings of variable contracts, offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, offerings of certain non-convertible debt or preferred securities, offerings of certain securities issued in conversions, stock splits and restructuring transactions, offerings of securities of a commodity pool operated by a commodity pool operator, business combination transactions, offerings of registered investment companies, standardized options and offerings filed with FINRA under Rules 2310, 5110, 5121 and 5122, or exempt from filing thereunder in accordance with Rule 5110(b)(7).

FINRA will treat all information it receives pursuant to the Rule as confidential and will use such information solely for determining compliance with applicable FINRA rules or other regulatory purposes deemed appropriate by FINRA. ■

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NASDAQ Proposes to Expand an Exception to its Corporate Governance Rules

Recently, NASDAQ proposed expanding an existing exception to its corporate governance rules to allow a non-independent director who is a family member of a non-executive employee of a listed company to serve on a listed company's audit committee, compensation committee or nominating committee under exceptional and limited circumstances.

Generally, NASDAQ's rules prohibit a listed company from appointing non-independent directors to audit, compensation and nominating committees. A director is not independent if, in the opinion of the

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Don't Leave Home Without These Clauses in Your Confidentiality Agreement

Two recent Delaware cases remind us of important provisions in confidentiality agreements entered into in connection with potential acquisitions.

In the typical friendly, negotiated acquisition, both parties will enter into a confidentiality agreement or non-disclosure agreement (referred to in lawyer-speak as a "CA" and "NDA,"

respectively, but really the same thing). The main purpose of these agreements is to allow the parties to provide confidential business, financial and other information about themselves to the other party for the purposes of evaluating a potential transaction and conducting "due diligence." Each receiving party agrees to keep the disclosing party's information confidential and not to use it, other than in connection with evaluating a potential transaction.

The first clause is the "standstill clause," which effectively prohibits either party from making a hostile bid or tender offer for the other party and specifically prohibits the use of confidential information for such purpose. This clause is typical in a CA involving public companies; however, even if the clause is missing, the court may still read it into the CA based on the other terms of the CA and the prior dealings

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FINRA AND EXCHANGE NEWS

NASDAQ Proposes to Expand an Exception to its Corporate Governance Rules (continued)

company's board, the director has a relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. Among other relationships, a director who is a family member of an individual who is, or any time during the past three years was, employed as an executive officer by the company is not independent; however, a director is not barred from being independent if he or she has a family member employed by the company, provided that the family member is not an executive officer of the company.

Under exceptional and limited circumstances and with proper disclosure[1], a board may allow one non-independent director to serve on the audit, compensation or nominating committee for up to two years (the Exception). The Exception, however, has not been available for a non-independent director who has a family member who is a *non-executive* employee of the listed company, even if the director is not independent for a reason unrelated to his or her relationship with the employed family member. Thus, even though a family relationship with a non-executive employee would not, by itself, preclude the director from being considered independent, the Exception is still not available for such a director.

Recognizing the incongruity under the current rules, NASDAQ has proposed to revise its Listing Rules to permit a listed company to rely on the Exception for a director who has a family relationship with a non-executive employee where the company's board has determined that the director's membership on the relevant committee is in the best interests of the company and its stockholders. NASDAQ expects that a board would take into account the family relationship between the non-independent director and non-executive employee in determining the best interests of the company and its stockholders. However, if the proposed rules are approved by the SEC, the mere existence of a family relationship with a non-executive employee will no longer create an outright prohibition on the use of the Exception. ■ Return to Table of Contents

INVESTMENT ADVISER REGULATION

Political Contributions by Certain Investment Advisers: Ban on Third-Party Solicitation; Extension of Compliance Date

The SEC extended the compliance date for the third-party solicitor provisions of Rule 206(4)-5 of the Advisers Act (the Pay-to-Play Rule). The Pay-to-Play Rule, among other things, prohibits an adviser from providing or agreeing to provide, directly or indirectly, compensation to any person to solicit a government entity for investment advisory services on behalf of such adviser unless the person is an executive officer, general partner, managing member or employee of the adviser, or such person is a registered investment adviser, a registered broker-dealer, or a registered municipal adviser.

The SEC extended the compliance date for the third-party solicitor provisions of the Pay-to-Play Rule until nine months after the compliance date of a final rule adopted by the SEC related to the registration of municipal advisor firms. Once the final rule regarding the registration of municipal advisor firms is adopted, the SEC will issue the new compliance date for the ban on third-party solicitations. ■

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PRACTICE TIPS

Don't Leave Home Without These Clauses in Your Confidentiality Agreement (continued from page 3)

of the parties. In *Martin Marietta Materials, Inc.* v. *Vulcan Materials Co.*[2], the Delaware Chancery Court interpreted a CA that was originally entered into in connection with a friendly potential acquisition to bar the use of confidential information in a hostile bid by one party (Martin Marietta) for the other (Vulcan), even though the CA did not contain an express standstill provision, and enjoined the hostile bid for a period of four months. The moral of the story is: include a standstill provision in your CA from the start and save yourself the litigation expense and sleepless nights experienced by Vulcan in this case.

The second clause of note is a "non-reliance" provision, in which the receiving party acknowledges that the disclosing party is not making any representation as to the accuracy or completeness of the confidential materials supplied and that the disclosing party will not have any liability for the supplied materials. This clause is typically supplemented by a waiver provision in which the receiving party waives any claims it might have in connection with any potential transaction unless the parties have entered into a definitive purchase agreement. In *RAA Management LLC* vs. *Savage Sport Holdings,* Inc.[3], the Delaware Supreme Court relied on fairly typical non-reliance and waiver clauses in a CA to uphold a decision dismissing a suit by a potential acquirer against a target that failed to disclose significant liabilities early in the due diligence process. The would-be acquirer sued for $1.2 million in due diligence and negotiation costs that it incurred before it learned of the potential liabilities and terminated the process. The Court ruled that the non-reliance and waiver provisions barred the potential acquirer's suit, even claims based on fraud or intentional misrepresentation, and upheld the lower court's dismissal.

Both cases serve as a reminder to practitioners and clients alike that there is significant value in crafting a well-drafted CA. ■

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SEC Comments Related to Emerging Growth Companies

Since shortly after the JOBS Act became law, the SEC staff has been reviewing registration statements filed by emerging growth companies (EGCs). While parts of the JOBS Act are not effective until the SEC issues implementing rules (such as the crowdfunding provisions), other parts of the JOBS Act became effective when the JOBS Act became law, including provisions related to disclosures by EGCs in their SEC filings and certain other requirements. EGCs are not subject to the requirement for an auditor attestation of internal controls pursuant to Section 404(b) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act) and certain provisions of the Dodd-Frank Act including: (i) requirements to disclose CEO pay-ratio information and the relationship between the company's financial performance and executive compensation; and (ii) requirements for advisory votes on golden parachute payments and say-on-pay and say-when-on-pay votes. In addition, EGCs are required to present two, rather than three, years of audited financial statements in registration statements and can take advantage of longer phase-in periods for changes to financial accounting standards.

It seems that the SEC has developed a standard set of comments it issues upon its review of registration statements filed by EGCs. In general, the comments ask EGCs to: (i) indicate on the cover of their registration statement that the company is an EGC; (ii) describe how and when a company may lose EGC status; (iii) briefly describe the various exemptions that are available to the company as an EGC; and (iv) indicate the company's election under Section 107(b) of the JOBS Act with respect to whether or not to comply with new financial accounting standards on the same time-table as reporting companies that are not EGCs, rather than taking advantage of the longer phase-in periods that may be available pursuant to Section 102(b) of the JOBS Act.

In addition, the SEC is asking EGCs that have opted out of the extended transition period for complying with new or revised accounting standards as permitted under Section 102(b) of the JOBS Act to state in their registration statement that the election is irrevocable. For those EGCs that do not opt out, the SEC is requesting that a risk factor, and a similar statement in the critical accounting policy disclosures, be included:

> "explaining that this election allows [the company] to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies … [and] that, as a result of this election, [the company's] financial statements may not be comparable to companies that comply with public company effective dates."

The SEC's comments appear to have generated little, if any, controversy. Interestingly, a number of EGCs that have responded to comment letters have opted out of the extended transition period for complying with new or revised accounting standards. Furthermore, a number of companies have also opted out of taking advantage of the reduced disclosure requirements for EGCs relating to executive compensation and the available exemptions from requirements relating to say-on-pay. It will be interesting to see whether opting out will continue as a trend or whether it is the result of companies having been prepared to become public under the pre-emerging growth company rules. ■ Return to Table of Contents

LEGISLATIVE CORNER

Insurance for Compensation Clawbacks? Not if H.R. 5860 Becomes Law

Both the Sarbanes-Oxley Act and the Dodd-Frank Act contain compensation clawback provisions. Under the Executive Compensation Clawback Full Enforcement Act (Full Enforcement Act) introduced by Representative Barney Frank, insurance providing coverage to executives of certain financial institutions for compensation clawbacks would be prohibited.

Section 304(a) of the Sarbanes-Oxley Act provides that the chief executive officer and chief financial officer of a company must reimburse it for: (i) any bonus or other incentive-based or equity-based compensation received by that person from the company during the 12-month period following the first public issuance or filing with the SEC (whichever first occurs) of the financial document embodying the financial reporting requirement under the securities laws, which the company was in material non-compliance with *due to misconduct* and in connection with which the company had to prepare an accounting restatement; and (ii) any profits realized from the sale of securities of the company during that 12-month period. This clawback provision can be used by the SEC even if the chief executive officer or chief financial officer of the company is not personally charged with the underlying misconduct.

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LEGISLATIVE CORNER

Insurance for Compensation Clawbacks? Not if H.R. 5860 Becomes Law (continued)

The Dodd-Frank Act expands the SEC's clawback authority. The Dodd-Frank Act requires the SEC to issue rules directing national securities exchanges to prohibit the listing of any security of a company that does not adopt a policy providing for the recovery of any incentive-based compensation (including stock options) awarded to current or former executive officers during the three-year period prior to an accounting restatement resulting from material noncompliance of the issuer with financial reporting requirements in excess of what would have been paid to the executive officer under the accounting restatement. The Dodd-Frank Act's clawback provisions are far more expansive than Section 304. Among other things, the Dodd-Frank Act covers not only the chief executive officer and chief financial officer, but all other executive officers, present and former, and does not require misconduct to trigger a clawback.

Section 210(s) of the Dodd-Frank Act also allows the FDIC, when acting as a receiver of a "covered financial institution," to recover from any current or former senior executive or director substantially responsible for the failed condition of the covered financial institution any compensation received during the two-year period preceding the date the FDIC was appointed as the receiver (provided that in cases of fraud, there is no time limitation).

The Full Enforcement Act would prohibit officers, directors employees and other institution-affiliated parties of certain enumerated financial institutions from, directly or indirectly, insuring or otherwise hedging against any personal liability to repay previously earned compensation or the payment of civil monetary penalties, subject to certain exceptions (most notably, that defense costs may be insured) where the personal liability arises under any "Federal financial regulatory law" (which is defined to include most securities laws) or any rule or order promulgated by a Federal financial regulatory agency. Both the Sarbanes-Oxley Act and the Dodd-Frank Act are included in the definition of Federal financial regulatory law.

The practical impact of the Full Enforcement Act if it becomes law is unclear. First, it is unclear whether insurance covering clawbacks is widely available. Second, the Full Enforcement Act does permit insurance coverage for defense costs, which can be very significant. Third, it applies only to a limited group of financial institutions, not all public companies. Fourth, any insurance product available is unlikely to provide coverage for clawbacks that result from fraud or intentional misconduct. ■

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ENDNOTES

1. A listed company that utilizes the Exception for an audit, compensation or nominating committee member must disclose either on or through the company's website or in the proxy statement for the next annual meeting (or, if the company does not file a proxy, in its Form 10-K or 20-F, the basis for categorizing the director as non-independent and the reasons for the determinations to rely on the Exception. A listed company that relies on the Exception for an audit, compensation or nominating committee member must also provide relevant disclosures required by Instruction 1 to Item 407(a) of Regulation S-K. Return to Article
2. *Martin Marietta Materials, Inc.* v. *Vulcan Materials Co.,* C.A. 7102-CS (Del. Ch. May 4, 2012). Return to Article
3. *RAA Management LLC* v. *Savage Sports Holdings Inc.,* Del., No. 577, 2011 (May 18, 2012). Return to Article ■

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QUESTIONS: If you have a question regarding the issues raised in this newsletter, you may obtain additional guidance from the authors and other members of our Public Companies Group.

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