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Treasury Outlines Compensation Practices Reform and Issues Interim Final Rule on TARP Compensation Standards

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On June 10, the U.S. Department of Treasury (the Treasury Department) outlined a set of broad-based principles regarding compensation practices for companies to follow, particularly those companies in the financial sector, which it believes will encourage sound risk management, long-term growth, and value creation; align compensation practices with the interests of shareholders; and ultimately reinforce the stability of firms and the financial system. The Treasury Department specifically stated that its intention is not to cap pay.

The principles are as follows:

- Compensation plans should properly measure and reward performance
- Compensation should be structured to account for the time horizon of risks
- Compensation practices should be aligned with sound risk management
- Golden parachutes and supplemental executive retirement benefits should be reexamined to determine whether they align the interests of executives with shareholders
- Transparency and accountability should be promoted in the process of setting compensation

In addition, the Treasury Department stated that it supports congressional efforts to pass "say on pay" legislation that would give the U.S. Securities and Exchange Commission (SEC) authority to require all public companies to give shareholders a nonbinding vote approving or disapproving executive compensation generally and golden parachute compensation relating to a merger, acquisition, or other transaction that involves a change in control of the company. The United Kingdom adopted "say on pay" legislation in 2002, and some "say on pay" initiatives have been presented by shareholder advocates in the United States. As discussed below, institutions receiving financial assistance under the Troubled Asset Relief Program (TARP) are already subject to this requirement, resulting in a track record on "say on pay" processes and results.

The Treasury Department also stated it will propose legislation that directs the SEC to promulgate rules requiring compensation committee members of companies listed on a national securities exchange to meet enhanced standards of "independence" similar to those required for audit committee members under the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). It is unclear at this time what form the heightened independence requirements will take, since various rules and regulations (e.g., section 162(m) of the Internal Revenue Code of 1986, as amended (the Code), and section 16 of the Securities Exchange Act of 1934, as amended) already require independent committee members. In addition, compensation committees would be given the responsibility and funding to retain their own compensation consultants and outside legal counsel, and such advisors would also be required to be deemed "independent," which is currently not required and would represent a material change in practices.

The Treasury Department announcement with links to two accompanying factsheets, "Ensuring Investors Have a Say on Pay" and "Providing Compensation Committees New Independence," is available at http://www.ustreas.gov/press/releases/tg163.htm.

Treasury Issues Interim Final Rule on TARP Compensation Standards

On June 10, the Treasury Department issued an interim final rule regarding compensation and corporate governance restrictions under TARP (the Regulations), effective June 15, 2009, which provide for the following:

- Implement the provisions in the American Recovery and Reinvestment Act of 2009 (ARRA) relating to compensation and corporate governance for entities that receive or have a commitment to receive financial assistance from the Treasury Department under TARP (TARP recipients)
- Establish additional compensation and corporate governance standards for TARP recipients
- Establish the Office of the Special Master for TARP Executive Compensation (Special Master)

The Regulations are available at http://edocket.access.gpo.gov/2009/pdf/E9-13868.pdf.

Previous guidance interpreting and supplementing the compensation and corporate governance standards for TARP recipients in the Emergency Economic Stabilization Act of 2008 (EESA) is superseded by the Regulations. However, IRS Notice 2008-94, which requires TARP recipients to forgo any deduction for compensation for federal income tax purposes in excess of $500,000 for each senior executive officer under section 162(m)(5) of the Code, remains in effect.

Compensation and Corporate Governance Standards for TARP Recipients

The compensation and corporate governance standards for TARP recipients apply to the five "named executive officers" identified in the company's proxy statement or other annual compensation disclosure (the senior executive officers, or SEOs), which includes the principal executive officer (i.e., CEO), the principal financial officer (i.e., CFO), and the three most highly compensated executive officers. In certain instances, the standards also apply to a specified number of the next most highly compensated employees (HCEs) or the entire employee population. Specifically, HCEs are employees (irrespective of whether they are executive officers) of the TARP recipient, other than the SEOs, whose annual compensation is highest among all employees of the TARP recipient for the last completed fiscal year regardless of whether the compensation was includible in gross income for federal income tax purposes. Annual compensation for this purpose is generally determined pursuant to Item 402(a) of Regulation S-K under the federal securities laws (private companies are to apply the public company rules by analogy). The Regulations provide additional guidance as to how to determine the applicable HCEs. The Regulations also provide guidance as to which entities are subject to the restrictions, including special rules for acquisitions, mergers and reorganizations.

Generally, the requirements, which apply during the period that financial assistance remains outstanding (the Restriction Period), are as follows:

- ***Prohibition on Severance Payments.*** TARP recipients are prohibited from making any "golden parachute" payment (i.e., *any* payment (not limited to amounts in excess of a "base amount" as under section 280G of the Code) for the departure for any reason or any payment due to a change in control of the TARP recipient, except for payments for services performed or benefits accrued) to a SEO or the next five HCEs.

- ***Limitations on Bonuses (with Exception for Certain Restricted Stock Awards).***

  - TARP recipients are prohibited from paying or accruing any bonus (excluding certain qualifying commissions), retention award, or incentive compensation, except that the prohibition does not apply to awards of long-term restricted stock that satisfy certain conditions.

  - Specifically, to qualify for the exception for certain long-term restricted stock awards, (i) the value of the long-term restricted stock (or restricted stock units) must not exceed one-third (1/3) of the employee's total annual compensation as calculated for that fiscal year, (ii) the long-term restricted stock may not become transferable (or payable, in the case of restricted stock units) earlier than as prescribed by a schedule in the Regulations (e.g., 25% of shares granted may become transferable when 25% of the aggregate financial assistance received is repaid, with incremental 25% of shares becoming transferable when corresponding 25% of aggregate financial assistance is repaid), and (iii) the employee receiving the award must be required to forfeit the restricted stock if the employee does not continue performing substantial services to the TARP recipient for at least two years following the grant date, except in certain circumstances (e.g., death, disability).

  - SEOs are subject to this bonus limitation; the number of HCEs subject depends on the amount of financial assistance received by the TARP recipient (up to the next 20 HCEs).

  - There is an exception that provides that any bonus payment required to be paid pursuant to a valid written contract (including an employment contract or elective deferral election under a qualified retirement plan or nonqualified deferred compensation plan) is not prohibited by this provision if the employee retained a legally binding right to the bonus payment on or before February 11, 2009. The Regulations provide various examples to illustrate this "grandfather" provision, one of which is the following: if a SEO participated in a written annual bonus program that grants discretion to the board of directors to eliminate or reduce the bonus of any employee in the bonus pool, and on January 15, 2009 the compensation committee determined the amount of the bonuses to be paid and set a payment date of June 1, 2009 for the payment of such bonuses, then the payment of such bonus to the SEO would not be subject to the bonus limitation.

- ***Clawback Imposed for Any Bonus Based on Materially Inaccurate Performance Criteria.*** A provision is required for the recovery by the TARP recipient of any bonus, retention award, or incentive compensation if the payment was based on materially inaccurate financial statements (which includes, but is not limited to, statements of earnings, revenues, or gains) or any other materially inaccurate performance metric criteria. This clawback provision, which is broader in scope than the clawback in Sarbanes-Oxley, is also broader in applicability as it applies to the SEOs and the next 20 HCEs. The Regulations require that the TARP recipient actually exercise its clawback rights unless the TARP recipient can demonstrate that it would be unreasonable to do so (e.g., if the expense of enforcing the clawback right would exceed the amount to be recovered).

- ***Prohibitions on Plans That Encourage Unnecessary and Excessive Risks, Pose Unnecessary Risks to the TARP Recipient, and Encourage the Manipulation of Reported Earnings.*** There are prohibitions on SEO compensation plans that encourage SEOs to take unnecessary and excessive risks that threaten the value of the TARP recipient, employee compensation plans that pose unnecessary risks to the TARP recipient, and employee compensation plans that encourage the manipulation of reported earnings to enhance the compensation of any of the TARP recipient's employees. These prohibitions require various timely discussions, evaluations, reviews with senior risk officers, and, ultimately, certifications and disclosures by the compensation committee. The Regulations do not define "unnecessary and excessive risks," but do indicate that plan features that encourage behavior focused on short-term results rather than long-term value creation are problematic.

- ***Corporate Policy on Luxury and Excessive Expenditures.*** The board of directors of each TARP recipient must adopt and, if a company website is maintained, post on its website a companywide policy on excessive or luxury expenditures that includes any expenditure not reasonable for staff development, performance incentives, or other similar measures conducted in the normal course of business and specifically includes the following four categories of expenses: (i) entertainment or events; (ii) office and facility renovations; (iii) aviation or other transportation services; and (iv) other similar items, activities, or events for which the TARP recipient may reasonably anticipate incurring expenses or reimbursing an employee for incurring expenses. The Regulations require that the policy mandate prompt internal reporting of any violations of the policy, and that the CEO and the CFO of each TARP recipient certify that the approval of any expenditure required to be approved by the board of directors (or committee thereof), a SEO, or any executive officer of a substantially similar level of responsibility was properly obtained.
- ***"Say on Pay" Requirement.*** The Regulations require TARP recipients to permit a separate shareholder vote to approve the compensation of executives consistent with regulations or guidance promulgated by the SEC. On February 24, 2009, the SEC issued interpretations that provided that the ARRA "say on pay" requirement was effective on February 17, 2009 and thus applicable for proxy statements filed with the SEC after February 17, 2009.
- ***Additional Disclosure of Perquisites.*** Expanding upon required SEC disclosure, TARP recipients must disclose any perquisites or other personal benefits with total value exceeding $25,000 provided to the SEOs and HCEs subject to the bonus limitation discussed above. TARP recipients must provide a narrative description of the amount and nature of these perquisites and justification for offering the benefit. TARP recipients must provide this disclosure to their primary regulatory agencies and to the Treasury Department.
- ***Prohibition of Tax Gross-Ups.*** TARP recipients are prohibited from providing "gross ups" (i.e., any reimbursement of taxes owed on any compensation, such as golden parachutes and perquisites; provided, however, that a gross-up does not include a payment under a specified tax equalization agreement) to any SEO and the next 20 HCEs.
- ***Disclosure of Compensation Consultants.*** The compensation committee of the TARP recipient must provide annually a narrative description of whether the TARP recipient, the board of directors, or the compensation committee engaged a compensation consultant. If so, a description of the services provided by any such consultant, including non-compensation-related services provided by the consultant or any of its affiliates, as well as a description of the use of any "benchmarking" procedures in the consultant's analysis must be provided. TARP recipients must provide this disclosure to their primary regulatory agencies and to the Treasury Department.
- ***Certification Requirements.*** The CEO and CFO must provide various written certifications as to compliance with the aforementioned compensation and corporate governance restrictions. Such certifications are required as an exhibit to applicable SEC filings and to the Treasury Department. A private TARP recipient must provide certifications to its primary regulatory agency and to the Treasury Department. The Regulations contain model certifications.

Office of the Special Master for TARP Executive Compensation

The Treasury Department established the position of Special Master, who will be responsible for interpreting and making determinations regarding EESA, the Regulations, and other applicable guidance. The Special Master will oversee the review of bonuses, retention awards, and other compensation paid before February 17, 2009 by all TARP recipients receiving any financial assistance prior to such date to determine whether any such payments were inconsistent with the purposes of EESA or TARP or were otherwise contrary to the public interest. The Special Master will make this determination by applying principles relating to risk, taxpayer return, appropriate allocation, performance-based compensation, comparable structures and payments, and employee contribution to TARP recipient value outlined in the Regulations. Where appropriate, the Special Master will negotiate appropriate reimbursements.

With respect to TARP recipients that have received "exceptional financial assistance" under the Programs for Systemically Significant Failing Institutions, the Targeted Investment Program, the Automotive Industry Financing Program, and any new program designated as providing exceptional financial assistance, the Special Master will review and approve any compensation proposed to be paid to the employees subject to the bonus limitations (i.e., generally SEOs and next 20 HCEs). Furthermore, the Special Master will review and approve the structure of compensation for the next 100 HCEs who are not subject to the bonus restrictions and any executive officers who are not among the next 100 HCEs. The Special Master has the authority to disapprove arrangements found to be inappropriate and require the company to resubmit. The Special Master will automatically approve proposed compensation if the employee's total annual compensation is not more than $500,000, with any additional compensation paid in the form of qualifying long-term restricted stock.

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