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Subject: **Treasury Issues New Executive Pay Guidelines under TARP**

Major References: ***(1) Treasury Documents: (a) Treasury News Release on New Executive Pay Guidelines (issued February 4, 2009), (b) Treasury News Release on Reporting and Recordkeeping Requirements under TARP (issued January 16, 2009), (c) Letter from Senator Kerry to Treasury Secretary Geithner dated February 4, 2009; (2) Interim Final Rules issued by Treasury regarding the reporting and recordkeeping requirements; (3) Revised Treasury Notice 2008-PSSFI; (4) Frequently Asked Questions issued by the Treasury relating to the executive compensation standards under TARP; and (5) Cap Executive Officer Pay Act of 2009 (S. 360)***

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In response to the growing public displeasure over the amount of compensation paid to the executives of the companies participating in the Troubled Asset Relief Program ("TARP") as well as the recent disclosure that over $18 billion in year-end bonuses were paid to Wall Street executives, on February 4, 2009, the Treasury announced new executive pay guidelines for the companies participating under TARP. The new guidelines generally will apply prospectively to companies entering TARP or expanding their participation in TARP after the new guidelines are fully implemented. These new guidelines come on the heels of guidance issued in January 2009 regarding the executive compensation reporting and recordkeeping requirements under TARP. In addition, on January 30, 2009, Senator Claire McCaskill (D-MO) introduced the "Cap Executive Officer Pay Act of 2009" (S. 360), which would limit the total compensation paid to any director or employee of a company participating in TARP to

> ***the amount of compensation paid to the President of the United States (currently $400,000). Moreover, in a letter dated February 4, 2009, Senator John Kerry (D-MA) asked Treasury Secretary Geithner to support legislation that Senator Kerry will be proposing which would modify the $1 million deduction limit on compensation paid to the top five executives of publicly-traded companies by, among other modifications, eliminating the exceptions for commission and performance-based pay and limiting the amount of nonqualified deferred compensation that could be deducted.***

Background

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008, which, among other matters, created the Troubled Asset Relief Program ("TARP"), a program administered by the Treasury to purchase assets and equity from financial institutions and other organizations to strengthen the financial sector. TARP authorized the Treasury to spend up to $700 billion. The first $350 billion was spent by the Bush Administration and the Senate recently approved the release of the second $350 billion to be spent by the Obama Administration.

As a condition to participating in TARP, EESA required companies to adopt certain executive compensation standards and enacted new limitations on the amount of executive compensation that could be paid. To date, the Treasury has created three programs under TARP: (1) the Troubled Asset Auction Program ("TAAP"), to purchase troubled mortgage-related assets through auction format, (2) the Capital Purchase Program ("CPP"), to provide equity capital under standardized terms directly to certain financial institutions, and (3) the Programs for Systemically Significant Failing Institutions ("PSSFI"), to provide direct assistance to certain firms on terms negotiated on a case-by-case basis.

On October 14, 2008, the Treasury issued the following four items of guidance regarding the compensation standards and limitations under TARP: (1) IRS Notice 2008-94, (2) Interim Final Rules under Section 111(b) of EESA, (3) Treasury Notice 2008-TAAP and (4) Treasury Notice 2008-PSSFI (see our Bulletin No. 08-96). These new executive compensation rules generally applied to the chief executive officer, chief financial officer, and the next three most highly compensated executive officers.

At the time these programs were initially established, the Treasury indicated that a significant portion of the authorized funds would be provided under TAAP. However, as a result of a change in strategy by former Treasury Secretary Paulson, none of the funds were used under TAAP. The first $350 billion was used under CPP and PSSFI. On February 10, 2009, Treasury Secretary Geithner announced the broad outlines of new programs that may be implemented with respect to the second $350 billion, as well as potential additional expenditures.

New Executive Pay Guidelines

The guidelines distinguish between companies participating in generally available capital access programs (like the CPP) and companies needing "exceptional assistance." In this regard, the Treasury noted that companies needing more assistance than is allowed under the generally available programs will have company-specific negotiated agreements with the Treasury.

(1) Companies Receiving Exceptional Financial Recovery Assistance - The new guidelines would impose the following enhanced conditions on executive compensation:

- Limit Compensation to $500,000 (except for restricted stock): The top-5 executives would be limited to no more than $500,000 in annual compensation, except for restricted stock awards (which are discussed further below). The Treasury compared this new restriction to the current programs that provide exceptional assistance, which only forbid the companies from taking a tax deduction for senior compensation above $500,000. This represents the first time the government has imposed a fixed dollar cap on the amount of compensation that can be paid. In the past, all other attempts to limit total executive compensation have been through deduction limits or excise taxes (or other tax disincentives).

- Unlimited Restricted Stock, but Payable Only When Government Fully Repaid: Any compensation in excess of $500,000 can only be provided through grants of restricted stock or other similar long-term incentive arrangements. In addition, the restricted stock can only vest when the government has been fully repaid with interest. The Treasury noted that such a restricted stock strategy would help assure that the senior executives would have incentives aligned with both the long-term interests of shareholders as well as minimizing the costs to taxpayers.

- Shareholder "Say on Pay": The senior executive compensation structure and the rationale for how compensation is tied to sound risk management must be submitted to a non-binding shareholder resolution. The Treasury noted that there are currently no "Say on Pay" provisions under the existing TARP programs.

- Bonus Clawbacks for Deceptive Practices: For the top-30 executives, the company must have in place provisions to claw back bonuses and incentive compensation if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay. Under the existing programs for exceptional assistance, these types of clawbacks only apply to the top-5 executives.

- Ban on Golden Parachute Payments: The top-10 executives would be prohibited from receiving any golden parachute payment upon severance from employment. In addition, the next 25 executives would be prohibited from receiving any golden parachute payment greater than one year's compensation. Under the existing programs, this ban on golden parachute payments only applies to the top-5 executives.

- Company Policy Relating to Approval of Luxury Expenditures: The board of directors of the company must adopt a company-wide policy on any expenditure related to aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events. The policy would have to require certification by the chief executive officer for expenditures that could be viewed as excessive or luxury items. In addition, companies would have to publish the text of the expenditures policy on their web sites.

(2) Companies Participating in Generally Available Capital Access Programs - The Treasury indicated that it intends to issue proposed guidance subject to public comment on the following executive compensation requirements relating to future generally available capital access programs:

- Total Compensation Limited to $500,000 Plus Restricted Stock Unless Waived by Shareholders: The same total compensation and restricted stock requirements that apply to companies receiving exceptional assistance (discussed above) would apply to companies

receiving generally available assistance for their top-5 executives except to the extent the executives' compensation was disclosed to the shareholders and, if requested, subjected to a non-binding "say on pay" shareholder resolution.

- Disclosures Regarding Excessive and Unnecessary Risk-Taking: The companies must review and disclose the reasons that compensation arrangements of both the top-5 executives and other employees do not encourage excessive and unnecessary risk-taking. The Treasury noted that the current CPP only required companies to review and certify that the top-5 executives' compensation arrangements did not encourage excessive and unnecessary risk-taking.

- Bonus Clawbacks for Deceptive Practices: The same clawback requirements that apply to companies receiving exceptional assistance would apply to those in generally available programs. Thus, for the top-30 executives, the company must have in place provisions to claw back bonuses and incentive compensation if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay.

- Increase Ban on Golden Parachutes for Top-5 Executives: The top-five executives would not be allowed to receive a golden parachute payment upon a severance from employment greater than one-year's compensation. The Treasury noted that under the current CPP, the top-5 executives could receive golden parachute payments up to three year's compensation.

- Company Policy Relating to Approval of Luxury Expenditures: This is the same policy required for companies receiving exceptional assistance (as described above). Thus, the board of directors of the company must adopt a company-wide policy on any expenditures related to aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events. The policy would have to require certification by the chief executive officer for expenditures that could be viewed as excessive or luxury items. In addition, companies would have to publish the text of the expenditures policy on their web sites.

The Treasury Release also included a discussion of the steps the Treasury believes should be taken (i) to examine how company-wide compensation strategies at all financial institutions (not just those receiving government assistance) may have encouraged excessive risk-taking that contributed to current market events and (ii) to begin developing model compensation policies for the future, including the following:

- The Treasury and Securities and Exchange Commission should work together to require compensation committees of all public financial institutions - not just those receiving government assistance - to review and disclose executive and certain employee compensation arrangements and explain how these compensation arrangements are consistent with promoting sound risk management and long-term value creation for their companies and their shareholders.

- The compensation of top executives should include incentives that encourage a long-term perspective. In this regard, the Treasury noted that over the last decade there has been an emerging consensus that top executives should receive compensation that encourages more of a long-term perspective on creating economic value for their shareholders and the economy at large. Specifically, the Treasury explained that one idea worthy of serious consideration is requiring top

executives at financial institutions to hold stock for several years after it is awarded before it can be cashed-out as this would encourage a more long-term focus on the economic interests of the firm.

- The shareholders of financial institutions, even those not receiving government assistance, should have a non-binding resolution on both the levels of executive compensation as well as how the structure of compensation incentives help promote risk management and long-term value creation for the firm and the economy as a whole.

The release also noted that the Treasury will host a conference with shareholder advocates, major public pension and institutional investor leaders, policy-makers, executives, academics, and others on executive pay reform at financial institutions. Treasury will seek testimony, comment, and white papers on model executive pay initiatives in the cause of establishing best practices and guidelines on executive compensation arrangements for financial institutions.

Guidance on Reporting and Recordkeeping Requirements

On January 16, 2009, the Treasury issued a news release and the following three items of guidance regarding the reporting and recordkeeping requirements under TARP: (1) interim final rules regarding such requirements for the CPP, (2) a revised version of Treasury Notice 2008-PSSFI to add similar compliance reporting and recordkeeping requirements to PSSFI, and (3) Frequently Asked Questions relating to the executive compensation standards to assist financial institutions' compliance with these requirements.

The interim final rules require, among other matters, the chief executive officer to certify annually within 135 days after the financial institution's fiscal year end that the financial institution and its compensation committee have complied with all of the executive compensation standards under the CPP (see Bulletin 08-96). In addition, within 120 days of the closing date of the Securities Purchase Agreement between the financial institution and the Treasury, the chief executive officer is required to certify that the compensation committee has reviewed the senior executives' incentive compensation arrangements with the senior risk officers to ensure that these arrangements do no encourage senior executives to take unnecessary and excessive risks that could threaten the value of the financial institution. A chief executive officer must provide the 120-day and annual certifications to the TARP Chief Compliance Officer. In addition, the financial institution is also required to keep records to substantiate these certifications for at least six years following each certification and provide these records to the TARP Chief Compliance Officer upon request.

This reporting and recordkeeping guidance was issued in the last days of the Bush Administration. It is not clear the extent to which, if any, these guidance items are subject to the "freeze" imposed by the Obama Administration on pending regulations (see Bulletin No. 09-11).

Proposed $400,000 Cap on Total Compensation

On January 30, 2009, Senator McCaskill introduced the "Cap Executive Officer Pay Act of 2009" (S. 360), which would limit the total compensation paid to any director or employee of a company participating in TARP to the amount of compensation paid to the President of the United States, which is currently $400,000. For purposes of this cap, the term "compensation" is defined broadly to include wages, salary, deferred compensation, retirement contributions, options, bonuses, property, and any other form of compensation or bonus that the Treasury determines is appropriate. It should be emphasized that this proposed cap would apply to all directors and employees of a company, not just its senior executives.

Proposed Modifications to the $1 Million Deduction Limit

On February 4, 2009, Senator Kerry sent Treasury Secretary Geithner a letter asking for his support of legislation that Senator Kerry is expected to introduce which would modify the $1 million deduction limit on compensation paid to the top 5 executives of publicly-traded companies (i.e., Code section 162(m)). These proposed modifications would apply to all publicly traded companies and would not be limited to financial institutions or companies participating in TARP.

In the letter, Senator Kerry explained that his proposed legislation would repeal the exceptions for commission and performance-based compensation. Those are two significant exceptions that many companies use to avoid or minimize the impact of the $1 million limit. When Code section 162(m) was originally enacted, those exceptions were included to encourage companies to provide a greater portion of their total compensation to executives in the form of either commissions and/or performance-based pay.

The letter explains further that the proposed legislation would modify the process for determining the top 5 executives. Under current law, an employee subject to the $1 million deduction limit has to be an employee on the last day of the year. Under the modification, the top 5 would be determined taking into account anyone who was employed at anytime during the year. The $1 million limit would also be indexed for inflation under the proposed legislation. In addition, the letter indicates that the proposed legislation would limit the amount of nonqualified deferred compensation that could be deducted. However, the letter did not disclose the amount of the proposed limit.

Senator Kerry also emphasized that the proposed legislation would not limit the amount of salary that an executive could receive, but would limit the tax subsidy. Senator Kerry feels that taxpayers should not have to bear the cost of excessive compensation.

Closing

Executive compensation is certainly under intense scrutiny by many parties. The particular developments addressed in this *Washington Report*, although generally limited to or focused on financial institutions and/or those participating in TARP, are concerning for a number of reasons. To begin with, for the first time, the government has imposed a dollar cap on the amount of compensation that can be paid to an executive (i.e., $500,000 plus restricted stock). Now that this line has been crossed, it may become easier to extend the concept to other circumstances (e.g., all financial institutions, all public companies). In addition, the Treasury has expressly indicated that it is considering executive compensation reforms with respect to companies beyond those participating in TARP. The Treasury is in the process of analyzing how the current financial crisis developed and the changes that can be made to prevent a reoccurrence, including executive compensation reforms. Thus, it is extremely likely that some or all of the new standards imposed under TARP (as well as those to be developed in the future), will be extended to other companies. Finally, the new executive pay guidelines have more "teeth" than those originally issued in October 2008. There are real concerns about whether companies participating in TARP, particularly those under the exceptional assistance programs, will be able to attract and retain the executives needed to turn the companies around.

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