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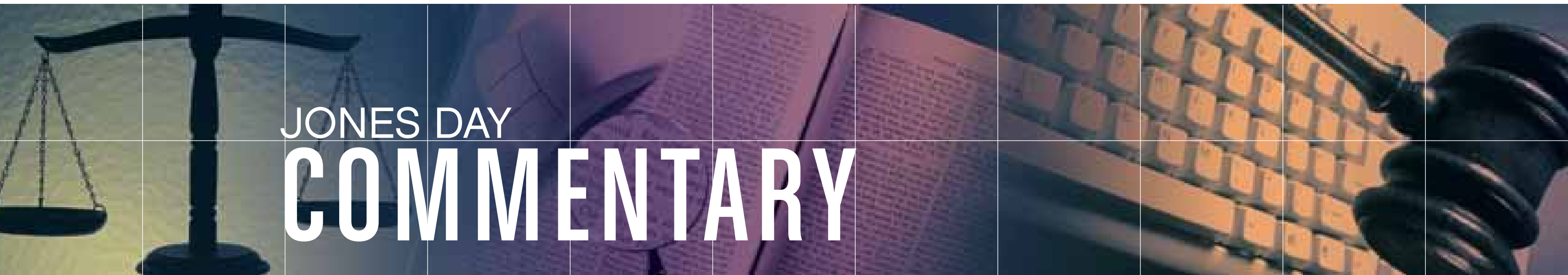


# TARP COMPENSATION GUIDANCE AND OTHER EXECUTIVE COMPENSATION PROPOSALS

The Department of the Treasury, the Securities and Exchange Commission, and Congress have continued their assault on executive compensation practices. Some of these recent measures will have an immediate impact on TARP recipients, while other actions prescribe guidelines or principles or set forth proposals for further consideration, all of which may influence or subsequently change compensation disclosure and "best" practices for all public companies.

## INTERIM FINAL RULE FOR TARP RECIPIENTS

The Department of the Treasury issued TARP Standards for Compensation and Corporate Governance regulations, effective June 15, 2009 (the "Interim Final Rule"), implementing executive compensation standards mandated under the Emergency Economic Stabilization Act of 2008 ("EESA"), as modified by the American Recovery and Reinvestment Act of 2009 ("ARRA"). The rules apply to senior executive officers ("SEOs"), as well as certain "most highly compensated employees,"[1] of institutions receiving financial assistance from the federal government under TARP. The rules supersede all prior related guidance.

Although the rules provide much-needed guidance on a number of questions left open by EESA and ARRA, they also create a new set of interpretive challenges for companies that will necessitate careful analysis of the rules and their effect on existing and future compensation arrangements for affected executives, continuing until a company has repaid its TARP assistance.

1. This group could go beyond the executive officer ranks. Unless the primary purpose for establishing or using a limited liability company, partnership or similar entity is to avoid or evade the restrictions set forth in EESA and the regulations, generally partners of partnerships and members of limited liability companies will be excluded.

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Significant features of the Interim Final Rule are summarized below.

**Bonus, Retention Award, and Incentive Compensation Prohibition.** Although payment of bonuses, retention awards, and incentive compensation is generally prohibited by ARRA, the rules clarify that long-term restricted stock,[2] certain commission payments (consistent with the company's past practice as of February 17, 2009), and certain bonus and other payments under employment contracts in effect on or before February 11, 2009 (with technical restrictions) will not be subject to the prohibition. The bonus limitations generally do not apply to amounts paid or accrued prior to June 15, 2009. Permitted long-term equity-based compensation has been expanded to include, in addition to restricted stock, the use of restricted stock units that are settled either in stock or cash. These equity awards must have a minimum two-year service vesting period following grant, with accelerated vesting permitted for death, disability, or a change in control. The equity awards are also subject to minimum holding (or payment) period requirements: 25% of the shares may become transferable (or payable) as each 25% of the TARP financial assistance is paid back. Restricted shares may become transferable earlier to the extent necessary to pay taxes due to vesting. Additionally, shares may become transferable (or payable) earlier due to a merger or acquisition. Despite the additional detail in the Interim Final Rule, there will be many interpretive questions regarding permissible long-term equity awards.

**Golden Parachute Prohibition.** The prohibition on so-called "golden parachute" payments to SEOs and the next five most highly compensated employees now covers payments made in the event of a change in control, as well as upon any termination of employment. Exceptions include payments for services performed or benefits accrued, qualified retirement plan (or foreign retirement plan) benefits, payments made by reason of death or disability of the employee, or severance payments required by state or foreign law.

**Gross-Up Prohibition.** A new prohibition on tax "gross-ups" for the SEOs and the next 20 most highly compensated employees is included, with an exception for certain international tax equalization arrangements. On its face, this prohibition may seem straightforward but could apply to tax gross-ups on unexpected benefits (i.e., certain health and other "make-whole" benefit provisions).

**Special Master Office for Interim Final Rule Oversight.** A "Special Master for TARP Executive Compensation" (popularly referred to as the "Pay Czar"), who will have broad powers to review compensation plans at TARP entities, has been established. In the case of such entities that are receiving "exceptional assistance," compensation payments to the SEOs and at least the next 20 most highly compensated employees must be submitted to the Special Master for approval. The Special Master also will be responsible for reviewing and approving the compensation structure applicable to the SEOs, all other executive officers, and the 100 most highly compensated employees. The Special Master has the authority to disapprove compensation it deems inappropriate, unsound, or excessive. The Special Master also will have the authority to issue advisory opinions, independently or in response to a TARP recipient (at its sole discretion), on whether a TARP recipient's compensation structure and/or payments are inconsistent with EESA or TARP or otherwise contrary to the public interest.

**No Base Salary Limitations.** Contrary to prior indications, the Interim Final Rule does not include any cap on base salary. In addition, base salary may be provided in vested stock or stock units that may be subject to holding period requirements and other limitations.

**Other Mandates—Clawbacks, Luxury Expenses.** The rules prescribe standards for determining whether bonus payments, retention amounts, or incentive compensation were based on materially inaccurate financial statements or performance metrics and mandate that the TARP recipient enforce the clawback unless it would be unreasonable to do so. Enhanced disclosure regarding perks and the TARP recipient's adoption of a written policy regarding excessive or luxury expenditures also is required.

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2. The value of the grant of long-term restricted stock may not exceed one-third of the employee's total annual compensation (which may be subject to other terms and conditions).

**Compensation Committees and Other TARP Recipient Directives.** TARP recipients and their compensation committees will be subject to additional requirements, including recordkeeping, conducting semiannual reviews of all employee compensation plans for unnecessary risk, and providing certifications and descriptions regarding their analysis and conclusions of risk assessment of SEO and other employee compensation plans.

## TREASURY STATEMENT ON COMPENSATION AND WHITE PAPER ON FINANCIAL REGULATORY REFORM

Treasury Secretary Timothy Geithner announced five broad-based principles on June 10, 2009—not necessarily limited to TARP recipients—that are intended to encourage "sound risk management" and "more tightly" align the compensation practices of companies and shareholders' interest, as well as reinforce individual company and financial system stability.

**Compensation Plans Should Properly Measure and Reward Performance.** Companies should consider whether performance metrics should be expanded to more broadly utilize other benchmarks that go beyond stock price, earnings per share, and other perceived short-term measures.

**Compensation Should be Structured to Account for the Time Horizon of Risk.** Although many companies already focus a significant portion of compensation on long-term achievement and payouts, a proper balance of alignment with risk horizons and the compensation mix may need to be further considered.

**Compensation Practices Should be Aligned with Sound Risk Management.** The Treasury has signaled that a new compensation "best practice" should include an assessment and publication of risk assessments by compensation committees to ensure that pay packages "do not encourage imprudent risk-taking."

**Golden Parachute and Supplemental Retirement Packages Should be Reexamined to Determine Proper Alignment With the Interests of Executives and Shareholders.** A comprehensive review and viability assessment by companies of these types of arrangements will be key. As noted in our Jones Day Commentary, May 2009, "Executive Compensation: Fundamental Change is Here, Are You Prepared?" the concept of severance, how it is paid, and what is paid may change as core questions are asked and answered.

**Promote Transparency and Accountability in the Process of Setting Compensation.** Although its ultimate significance remains unclear, "say on pay" is here (whether mandated by federal legislation for all public companies or via continued shareholder proposals), and companies will need to address this issue head-on. The Treasury has indicated that it intends to work with Congress to pass legislation on "say on pay" and on enhanced independence of compensation committees, including committees' responsibilities and resources to hire their own compensation consultants and outside consultants (modeled on standards set for audit committees by the Sarbanes-Oxley Act).

Some of these principles are already in place to varying degrees (e.g., independent compensation committees, long-term performance-based incentive compensation). Other principles may necessitate more formal assessments and greater "transparency and accountability" in the disclosure and compensation-determination process by boards of directors and senior management. The proposed "best" practice of risk assessment reports will better suit certain industries and may lead to changes in enhanced stock and incentive award retention policies. However, it may be too much of a one-size-fits-all approach for others, as the business of many companies may not inherently engender "excessively risky" compensation structures.

**Financial Regulatory Reform.** The Treasury Department's June 17, 2009, Financial Regulatory Reform proposals for financial firms generally incorporate the principles summarized above. The reform proposals go further, however, by providing that compensation for brokers, sponsors, underwriters, and others involved in the securitization process should be specifically linked to "the longer-term performance of the securitized assets" rather than only to the origination of the assets and that the SEC be empowered to examine and ban forms of compensation that encourage intermediaries to place investors in products not in the investors' best interests. [3]

3. A summary of the Financial Regulatory reform proposals is set forth in the Jones Day Commentary "Financial Regulatory Reform: Administration White Paper Advocates Increased Supervision and Regulation of Financial Firms, Markets, and Products," June 2009.

## SEC PROPOSALS

Securities and Exchange Commission Chairman Mary Schapiro also announced on June 10, 2009, that the SEC is considering enhanced compensation disclosure requirements for all public companies. In line with the Treasury's position of not attempting to place "caps" on pay, Chairman Schapiro stated that the Commission's role "has not been to set pay scales or compensation." Chairman Schapiro has repeatedly stated that she believes that it is critical to give shareholders the ability to "hold directors accountable for their compensation decisions," and that the Commission's goal is to ensure that investors have the information necessary to make "sound investment decisions."

To further the Commission's goal, the recently released proxy access proposal would give certain shareholders the right to place director candidates they nominate on a company's proxy card. To further reinforce Chairman Schapiro's view "that better disclosure of compensation leads to more informed shareholders and in turn to more accountable corporate directors," the Commission is also considering the following enhanced compensation disclosure modifications:

- Risk Management: Company and board approaches to managing risks of all types.
- Compensation Risk Management: A company's overall approach to the various compensation components.
- Relationships With Compensation Consultants: Potential conflicts of interest by compensation consultants and disclosure of relationships between the consultants and the company.
- Director Nominees: Enhanced disclosure on director nominees and their experience and qualifications to serve on the board or particular board committees.
- Leadership Structure: Disclosure that explains a board's rationale for its chosen leadership structure.

## CONGRESSIONAL INITIATIVES

Action by Congress to regulate executive compensation is continuing. At a hearing of the House Financial Services Committee on June 11, 2009, Committee Chair Barney Frank reiterated his strong preference for regulation of executive pay: "I believe the structure of compensation [is] flawed. Namely, we have had a system of compensation for top decision makers in which they are very well rewarded if they take a risk that pays off but suffer no penalty if they take a risk that costs the company money." Congressman Frank noted that Treasury Secretary Geithner's principles do not go far enough and indicated his desire to "adopt remedial legislation that mandates that the SEC adopt appropriate rules that embody these principles."

Another bill attempting to regulate executive compensation (also not restricted to TARP recipients) was introduced on June 12, 2009, by Congressman Gary Peters, a member of the Financial Services Committee. This bill, the Shareholder Empowerment Act, H.R. 2861, reflects the Treasury Department's legislative proposals summarized above, and advances numerous other initiatives to regulate executive compensation, including some of those put forth by Senator Charles Schumer in the Shareholder Bill of Rights Act of 2009, S. 1074 (e.g., require a split of the Chairman and CEO roles). In addition, the Shareholder Empowerment Act would seek to require majority voting for directors, prohibit uninstructed broker votes in uncontested elections, prohibit compensation advisers from providing other consulting services in which they report to company management, enhance clawback provisions for fraudulent or faulty earnings statements, and prohibit severance for poor performance terminations.

## EXECUTIVE COMPENSATION PIPELINE

These latest developments underscore the different approaches that the federal government is taking on executive compensation in response to the financial crisis.

The Treasury prefers principles and guidelines, rather than substantive regulation of compensation. As Secretary Geithner stated on June 10th, "We are not capping pay. We are not setting forth precise prescriptions for how companies should set compensation, which can often be counterproductive. Instead, we will continue to work to develop standards that reward innovation and prudent risk-taking, without creating misaligned incentives."

The Treasury is constrained, however, by EESA and AARA, which necessitated the substantive pay provisions of the Interim Final Rule for TARP recipients.

The SEC emphasizes process and transparency, while retaining discretion.

Some members of Congress are focused on compensation limits, the "empowerment" of shareholders, and their right to have a stronger voice on executive compensation and the board members who oversee companies, as well as regulation of compensation through the federal tax code. As illustrated by Congressman Frank's statement, above, some in Congress embrace a heavy-handed, one-size-fits-all approach to regulating executive compensation, limiting discretion and substituting legislative judgment for that of company management and boards of directors.

Obviously, TARP companies should be mindful of the rulemaking and statutory provisions that expressly apply to them. Other companies, however, should be cognizant of the full range of governmental executive compensation initiatives, including those limited to TARP companies and those being proposed for all public companies, as they may provide insight into future regulatory trends and provide advance warning of renewed pressure from institutional shareholders, proxy advisers, and others.

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