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U.S. Treasury Department Announces New Restrictions on Executive Compensation for Financial Institutions

On February 4 the Treasury Department issued a press release containing numerous changes to the rules regulating the executive compensation arrangements of financial institutions receiving government assistance. The current rules were previously described in our October 17, 2008 letter.[1] The new guidelines apply to two sets of financial institutions: (1) those participating in generally available capital access programs and (2) those needing "exceptional assistance" that have individually negotiated agreements with the Treasury Department.[2] Some rules appear to be immediately applicable while others are subject to the issuance of future guidance.

This letter discusses the February 4 news release and certain additional guidance that the Treasury Department issued on January 16, 2009. While a portion of that additional guidance is currently on hold as part of a general freeze by the Obama administration on finalizing unpublished regulations of the Bush administration, the tenor of the February 4 news release suggests that rules at least as stringent as those in the frozen regulations are likely to be enacted.

House and Senate conferees are currently reconciling competing versions of the economic stimulus bills that have passed the House and Senate in the last few days. The Senate bill contains numerous provisions regulating executive compensation at financial institutions receiving government assistance. Depending on the results of these negotiations, new statutory limits may emerge in the very near future, which will be discussed in a future letter.

February 4 News Release -- Rules Applicable to Financial Institutions Participating in Generally Available Capital Access Programs

The current Capital Purchase Program ("CPP") under which financial institutions have been able to sell preferred stock to the Treasury Department is an example of a generally available capital access program. As described at length in our October 17, 2008 letter, four types of rules apply today to financial institutions participating in the CPP: Rule 1 - limits on incentive compensation to senior executive officers ("SEOs")[3] that encourage excessive risk taking; Rule 2 - clawback rules that apply to incentive compensation paid to SEOs; Rule 3 - limits on severance payments to SEOs; and Rule 4 - $500,000 deduction limit with respect to compensation paid to SEOs. Each of these four rules has been significantly modified and a new rule regarding luxury expenditures (Rule 5) has been added.

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1 See our letter of October 17, 2008, "Treasury Department Issues Executive Compensation Rules under the Capital Purchase Program for U.S. Financial Institutions," http://www.fwcook.com/alert_letters/10-17-08_Treasury_Department_Issues_Executive_Compensation_Rules_Under.pdf, which is available at our website at www.fwcook.com.

2 The news release lists AIG, Bank of America, and Citigroup as examples of such financial institutions.

3 Generally the SEOs of a company are the principal executive officer, principal financial officer, and the three most highly compensated executive officers, other than these two officers.

Rule 1 for All Financial Institutions. The CEO of a participating financial institution will be required annually to certify that the institution has "strictly" complied with all applicable compensation restrictions. In addition, the compensation committee must provide an explanation of how the executive compensation arrangements for SEOs do not encourage "excessive and unnecessary" risk-taking. These modifications apply to past and future recipients of government assistance.

- The CEO certification requirement is new. The new compensation committee risk explanation is in addition to the previous requirement that the committee certify that it had made reasonable efforts to ensure that the compensation arrangements did not encourage excessive risk-taking.[4]

The remaining modifications only appear to apply to participants in ***new*** generally available capital access programs (current and future participants in the current CPP appear exempt from the changes). The modifications for "New General Program Participants" are:

Rule 1. The certification requirement that compensation programs do not encourage excessive risk taking will be expanded from SEOs to all employees. According to the news release, the company must certify that none of the compensation arrangements for any employees encourage excessive and unnecessary risk taking. The news release does not indicate whether this requirement can be satisfied by persons other than the compensation committee members. This may be a critical issue since the number of employees and the international scope of some financial institutions makes it impossible for compensation committee members to review all applicable compensation arrangements.[5]

Rule 2. The clawback rules will be expanded to the next 20 most highly compensated senior executives after the SEOs if they have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay. The rule applicable to these additional executives is narrower than the rule applicable to SEOs, who are subject to a repayment obligation when the relevant metrics are inaccurate, regardless of whether they were knowingly involved in the creation of the inaccurate data.

Rule 3. The compensation limit on severance benefits to SEOs will be lowered to one year's compensation, as opposed to the three times limit under the current rules.

Rule 4. In addition to the $500,000 deduction limit, the release announces new rules that will limit the total annual compensation of an SEO to $500,000, excluding "restricted stock or other similar long-term incentive arrangements." Stock is considered restricted only if it cannot be "cashed in" until the government has been totally repaid for its financial assistance or a specified period of time has elapsed and conditions have been

4 The news release inaccurately states that the current requirement is that the compensation committee certify that the compensation arrangements do not encourage excessive risk-taking. In fact, the current requirement is limited to the committee certifying that it has made reasonable efforts to ensure that the arrangements do not encourage unnecessary and excessive risks.

5 Interestingly, a literal application of this new rule could impact standard commission arrangements, since they immediately compensate employees for specific transactions without regard to their overall riskiness or future financial impact. The application of the new rules to commissions should be watched closely.

satisfied that relate to the degree to which the financial institution has satisfied its repayment obligations, protected taxpayer interests, or met lending and stability standards.

- It is permissible to exceed this new limit if the additional compensation is disclosed (the manner of disclosure is not described) and, if requested, the financial institution provides its shareholders the opportunity to vote on a non-binding "say on pay" resolution with respect to the compensation.

- It should be noted that there is no statement in the news release that the $500,000 limit applies only to cash compensation. When the regulations implementing the items in the news release are issued they may include, for example, pension plan accruals and matching contributions to profit-sharing plans as well as the value of perquisites and welfare benefits.

Rule 5. Obviously responding to negative publicity over expensive perquisites, entertainment, and offsite conferences of companies receiving financial assistance, the news release states that financial institutions will need to adopt a company-wide policy on any expenditures relating to aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events. It is unclear whether this rule is intended to directly limit certain types of expenditures, as opposed to ensuring that the expenditures are disclosed. The release only states that the CEO must deliver a certification for expenditures "that could be viewed as excessive or luxury items."

February 4 News Release -- Rules for Companies Receiving Exceptional Financial Assistance

Modified Rule 2 and new Rule 5 are the same for "exceptional assistance companies" as they are for New General Program Participants, but Rules 1, 3, and 4, are significantly different.

Rule 1. In addition to its other requirements, there is now a requirement that the senior executive compensation strategy and the rationale for how compensation is tied to sound risk management be submitted to a non-binding shareholder resolution.[6]

Rule 3. Currently the programs for companies receiving exceptional financial assistance prohibit any severance payments to the SEOs. This ban will be extended to the top ten senior executives (including the SEOs). In addition, the next 25 executives will be limited to no more than one year's compensation as severance pay.

Rule 4. Unlike the rule for New General Program Participants, there is no exception to the limit on compensation of $500,000 plus restricted stock.

- The previous policy of deduction limits increased the price of financial assistance (by eliminating the company's tax benefits) but did not preclude companies from paying compensation in excess of the limit. The new policy will likely limit the pool of critical talent by reducing the compensation that can be offered.

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[6] Probably inadvertently, the news release does not indicate that the company must review the compensation arrangements of all employees for excessive riskiness.

February 4 News Release -- Other Provisions in the News Release

The release concludes by listing what it labels four components of long-term regulatory reform for all financial institutions in the future:

- The Secretary of the Treasury and the Chair of the SEC are directed to work together to require the compensation committees of all public financial institutions to review and disclose executive and certain employee compensation arrangements and how they are consistent with promoting sound risk management and long-term value creation.

- A requirement that top executives hold stock for several years after it is awarded and before it can be cashed out is labeled an "idea worthy of serious consideration."

- It is stated that shareholders should have the opportunity to vote on a non-binding resolution on both the structure and level of executive compensation.

- The Secretary of the Treasury is directed to host a conference on model executive pay initiatives for financial institutions.

January 16 Actions by the Treasury Department

On January 16, 2009, the U.S. Treasury Department issued several changes to the Interim Final Rule on executive compensation applicable to financial institutions that participate in the TARP Capital Purchase Program (CPP). As noted above, these changes were put on hold. The U.S. Treasury Department also issued on January 16, 2009 clarifications to the Interim Final Rule in the form of Frequently Asked Questions (FAQs). Our understanding is that the FAQs are in effect while the changes to the rule remain on hold.

January 16 Changes to Interim Final Rule (Not Currently in Effect)

Compliance and Reporting

- The CEO of a financial institution participating in the CPP must certify within 120 days of closing of the agreement with the Treasury Department for its investment in the financial institution that the compensation committee of the financial institution has met its risk-assessment requirement under the CPP.

- The CEO must also certify annually, within 135 days of each fiscal year end, that the financial institution and its compensation committee have complied with the Interim Final Rule requirements relating to risk assessment, the implementation of "clawback" provisions relating to bonus and incentive compensation for SEOs, prohibition on golden parachute payments, compliance with the $500,000 annual tax deduction limit for each SEO, and the names of the SEOs for the current fiscal year.

- These certifications are to be sent to the TARP's Chief Compliance Officer, and the financial institution must maintain records to support these certifications for six years.

- The compensation committee's certification that it has met with the senior risk officers and reviewed the incentive program of the SEOs "to ensure that these arrangements do not encourage SEOs to take unnecessary and excessive action that could threaten the value of the institution" has been moved from the Compensation Discussion & Analysis section of the proxy statement to the Compensation Committee Report.

Clawback Rules

The revised Interim Final Rule provides that the clawback rules (for recovery of compensation paid "based on materially inaccurate financial statements or other materially inaccurate performance metric criteria") apply to compensation earned during the period the Treasury Department holds an equity or debt position in the financial institution under the CPP, even if the compensation is not paid until after the Treasury no longer holds an equity or debt position.

January 16 FAQs (Currently in Effect)

Identifying Senior Executive Officers

The FAQs state that the SEO determination is made in two different ways, depending on whether the SEO determination is being made for non-tax related standards of the CPP or for the purpose of the $500,000 deduction limit on compensation that can be paid to SEOs.

For all purposes other than the $500,000 deduction limit, the SEOs for a year are those persons named in the proxy statement filed during that year, regardless of what the individual earns in the year that the proxy statement is filed. Thus, in the case of a calendar year corporation, an individual is an SEO for 2010 if he or she is identified as a named executive officer in the proxy statement filed in 2010 (based on compensation for 2009), regardless of his or her actual compensation in 2010. The FAQs further state that, if a potential SEO's employment is terminated before it is determined whether he or she is an SEO, the financial institution should delay paying any severance that might be subject to the CPP severance cap (2.99 times average W-2 pay for the five years preceding termination). In practice, this should not be a problem—since the SEO determination is based on data from the prior year, all the information necessary to determine SEO status is available at the time of termination.

With regard to the $500,000 deduction limit, the SEO determination is based on whether the officer meets the SEO definition in the year in which the deduction would otherwise be available. For example, an officer terminated in 2010 might not be an SEO for the purpose of the 2.99 limit on severance pay because he or she is not named in the 2010 proxy (which is based on 2009 compensation). The severance pay, however, might raise the officer's compensation for 2010 to a level where he or she is one of the three most highly compensated officers other than the CEO or CFO, so that he or she would be included in the proxy statement filed in 2011. In this case, the executive's deductible compensation for 2010 would be subject to the $500,000 limit.[7]

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[7] Unlike the SEC rules for determining named executive officers (which count the three highest compensated officers who are employed at the end of the year, plus any terminated officers whose

Golden Parachute Limitation

If an SEO is terminated during the period the Treasury Department holds equity or debt in the financial institution, the severance cap cannot be avoided by delaying the payment until the Treasury is no longer an equity or debt holder.

Applicability Period

The CPP executive compensation requirements are applicable as long as the Treasury Department holds "any equity or debt position in the financial institution under the CPP, including the Warrant or any equity acquired under the Warrant."

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice. General questions about this letter may be directed to David Gordon at 310-734-0111 (degordon@fwcook.com) or Richard Alpern at 212-299-3599 (rlalpern@fwcook.com). Specific questions should be referred to legal counsel. Copies of this letter and other published materials are available on our website at www.fwcook.com.

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compensation is at least as much as any of the three highest paid), the SEO rules appear to look at the three highest paid officers, regardless of whether they are employed at the end of the year. It may be possible for someone to be an SEO for a year regardless of whether he or she is employed at the end of the year.