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February 18, 2009

Congress Expands Restrictions on Executive Compensation for Financial Institutions under Troubled Asset Relief Program

Executive Summary

The American Recovery and Reinvestment Tax Act of 2009 (Act) that was signed into law on February 17, 2009 significantly expands the restrictions on executive compensation applicable to financial institutions receiving assistance under the Troubled Asset Relief Program (TARP) as part of the Emergency Economic Stabilization Act of 2008 and the rules implementing those restrictions.¹ The revised restrictions that apply to companies receiving TARP assistance are:

- Prohibition on certain bonus, retention and incentive compensation for senior executive officers (SEOs)² and up to 20 other employees
- Prohibition on golden parachute payments to CEOs and the 5 next most highly-compensated employees
- Required adoption of a company-wide policy on excessive or luxury expenditures
- Mandated “say on pay” shareholder vote on the compensation of executives
- Direction to the Secretary of the Treasury to review bonus, retention and other compensation paid to CEOs and the next 20 most highly-compensated employees that received TARP assistance prior to the Act to determine if the compensation was inconsistent with the purposes of the Act or TARP, or otherwise contrary to the public interest and, if so, seek to negotiate for reimbursements
- Prohibition on incentives that involve “unnecessary and excessive risks”
- Required “clawback” provisions to recoup bonus, retention and incentive compensation for CEOs and up to the next 20 most highly-compensated employees

¹ See our letters of October 6, 2008, “Congress Curbs Compensation of Executives under Financial Rescue Plan,” http://www.fwcook.com/alert_letters/10-06-08_Congress_Curbs_Compensation_of_Executives_Under_Financial_Rescue_Plan.pdf, 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, and February 11, 2009, “U.S. Treasury Department Announces New Restrictions on Executive Compensation for Financial Institutions,” http://www.fwcook.com/alert_letters/02-11-09_US-Treasury-Department-Announces-New-Restrictions.pdf which are available at our website at www.fwcook.com.

² The CEOs of a company are, generally, the chief executive officer (CEO), chief financial officer (CFO), and the three most highly compensated executive officers other than the CEO and CFO.

- Prohibition on any compensation plan that would encourage manipulation of earnings to enhance compensation
- Limitation on the tax deductibility of annual compensation of CEOs to \$500,000
- Requirement of an annual certification by the CEO and CFO of the company's compliance with the restrictions
- Requirement that the company establish a compensation committee consisting solely of independent directors to review employee compensation plans

This letter discusses the revised restrictions in more detail.³ It is expected that additional guidance will be shortly forthcoming because the revisions are effective immediately, and the meaning and application of many of the key concepts in the Act are unclear.

Standards to Be Established by the Secretary of the Treasury

Generally, each company that has received or will receive financial assistance under TARP (defined in the Act as a "TARP recipient") is subject, during the period that any obligation arising from the assistance remains outstanding (TARP Restriction Period), to standards to be established by the Secretary of the Treasury under the Act and the annual \$500,000 deduction limit on compensation for each CEO under section 162(m)(5) of the Internal Revenue Code⁴. The Act provides that the Secretary is to "... require each TARP recipient to meet appropriate standards for executive compensation and corporate governance" including the specific standards set forth below.

Prohibition on Bonus, Retention and Incentive Compensation. The number of employees affected by this prohibition varies depending on the amount of TARP financial assistance received by the TARP recipient, ranging from only the most highly compensated employee if the assistance does not exceed \$25,000,000 to the CEOs and at least the next 20 most highly-compensated employees if the assistance is at least \$500,000,000 (or such higher number as the Treasury Department determines "is in the public interest"). Under this prohibition a TARP recipient cannot pay or accrue any "bonus, retention award or incentive compensation" during the TARP Restriction Period, subject to an exception for "long-term restricted stock" that

- Does not fully vest during the TARP Restriction Period;
- Does not exceed more than one-third of the total amount of the annual compensation of the employee receiving the restricted stock; and
- Is subject to any other terms and conditions that the Secretary of the Treasury determines is in the public interest.

³ Although the Act does not contain an effective date for the executive compensation restrictions, our understanding is that they are intended to apply immediately and applied to financial institutions that previously received TARP assistance (even though the documents they executed indicated that they were only subject to the restrictions under the rules then in existence).

⁴ There is no exception to the deduction limit for performance-based compensation, including stock options, and the limit applies to partnerships and private corporations in addition to public corporations.

The prohibition does not apply to any bonus payment required by a written employment contract executed on or before February 11, 2009, subject to the Secretary's determination of what is a valid employment contract.

Since there are no definitions of the key terms of this provision (i.e., "bonus, retention award or incentive compensation," "long-term restricted stock," "does not fully vest" and "employment contract") a full understanding of the prohibition will have to await guidance from the Secretary.

Prohibition on Golden Parachute Payments. During the TARP Restriction Period, a TARP recipient may not make any payment to its CEOs and the 5 next most highly-compensated employees for departure from the company for any reason, except for payments for services performed or accrued benefits.

Prohibition on Incentives That Involve Unnecessary and Excessive Risks. During the TARP Restriction Period, a TARP recipient must have in place limits on compensation that exclude incentives for CEOs to take unnecessary and excessive risk that threaten the company's value.

Clawback Provisions. The TARP recipient must have in place a provision for the "clawback" (i.e., recovery) of any bonus, retention award or incentive compensation paid based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate. The clawback applies to the company's CEOs and its 20 next most highly-compensated employees. The Act does not limit this standard to the TARP Restriction Period.

Prohibition on Compensation Plans Encouraging Manipulation of Earnings. The TARP recipient must not have in place any compensation plan that would encourage the manipulation of the company's earnings to enhance the compensation of any employee.

Compensation Committee Consisting Solely of Independent Directors. The TARP recipient must establish a compensation committee consisting solely of independent directors to review employee compensation plans. The committee must meet at least semiannually to discuss and evaluate the company's compensation plans for employees in light of the committee's assessment of any risk to the company that the plans pose. If the TARP recipient does not have any stock registered under the Securities Exchange Act of 1934 and has not received more than \$25,000,000 in financial assistance, these requirements are to be carried out by the board of directors instead of the compensation committee.

Additional Requirements

In addition to the standards to be established by the Secretary of the Treasury, the Act also contains the requirements set forth below.

CEO and CFO Compliance Certification. The CEO and CFO of the TARP recipient must provide a written certification of the company's compliance with the compensation restrictions of the Act. If the TARP recipient has publicly traded securities, the certification must be provided to the Securities and Exchange Commission (SEC) as part of the company's annual required securities laws' filings. Otherwise, the certification will be provided to the Secretary of the Treasury.

Company-wide Policy on Excessive or Luxury Expenditures. The board of directors of the TARP recipient must adopt a company-wide policy on “excessive or luxury expenditures” that are identified by the Secretary of the Treasury. These may include excessive expenditures on entertainment and events, office and facility renovations, aviation or other transportation services, and “other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course” of the company’s business and operations.

Say on Pay Vote. At each annual or other meeting of the shareholders of the TARP recipient during the TARP Restriction Period, there must be a “say on pay” vote on the compensation of executives as disclosed under the proxy compensation disclosure rules issued by the SEC, including the compensation discussion and analysis, the compensation tables, and any related material. The Act provides that the shareholder vote will not be binding on the TARP recipient’s board of directors, and is not to be construed as (i) overruling any decision by the board, (ii) creating or implying any additional fiduciary duty by the board of directors or (iii) restricting or limiting shareholders from making other proposals for inclusion in proxy materials. The SEC is to issue final rules and regulations to implement this section by February 17, 2010.

Review of Prior Payments. The Secretary of the Treasury is to review bonus, retention and other compensation paid prior to the Act to CEOs and the next 20 most highly-compensated employees of a company that received TARP assistance to determine if the compensation was inconsistent with the purposes of the Act or TARP or was otherwise contrary to the public interest. If the Secretary makes such a determination, the Secretary is required to seek to negotiate with the TARP recipient and the applicable employee for reimbursement of the compensation to the Federal Government.

Repayment of TARP Assistance

The Act provides that a TARP recipient may repay any financial assistance it previously received, without being subject to the otherwise applicable requirement that the amount repaid be replaced with funds from any other source or be subject to a waiting period. By doing so, the compensation restrictions discussed in this letter would cease to apply. The repayment is subject to consultation by the Secretary of the Treasury with the appropriate Federal banking agency.

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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 Richard Alpern at 212-299-3599 (ralpern@fwcook.com) or David Gordon at 310-734-0111 (degordon@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.