Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles • San Francisco • Atlanta

April 28, 2009

Executive Compensation 2008 –
The Year in Review & The Road Ahead

Each year Frederic W. Cook & Co. issues a year-in-review letter summarizing the various “alert” letters issued throughout the year commenting on the major regulatory and technical developments related to executive compensation. This year the year-in-review letter is organized differently to help readers respond to the growing uncertainty in the world of executive compensation. Therefore, the body of this year’s letter is intended to provide a sense of what has happened over the last year and to help companies navigate the upcoming year and beyond. The letter comments on the issues companies are facing currently with regard to executive compensation in light of events in 2008 and raises questions intended to create discussion around what companies and directors should be thinking about in 2009 and beyond relating to executive compensation. As in previous year-in-review letters, the letter does summarize the “alert” letters issued throughout 2008. The summary has been included in the Appendix starting on page 8.

2008 was not for the faint of heart. The beginnings of a housing slowdown in late 2007 quickly accelerated into a full blown financial meltdown. The resulting effects have been monumental and unprecedented in the speed and magnitude in which these events have unfolded and continue to unfold:

- A collapse of the financial services industry led to the buckling of once iconic firms such as Lehman Brothers, Merrill Lynch, Bear Stearns, and AIG;
- Investors fled U.S. equities, sending the stock markets into a tailspin. The Dow Jones and S&P 500 indices were down approximately 35% and 40% in one year, respectively;
- Credit markets froze as banks, undercapitalized in light of enormous write downs to cover bad assets related to bets on the housing market, could not afford to lend;
- Governments all over the world intervened to try and prop up/bail out the financial industry by injecting trillions of dollars through various investment strategies;
- Investor and consumer confidence plunged;
- The ills of the financial industry spread quickly to other industries and, before we could catch our breath, a global recession began to take hold.

These events helped to set the backdrop for the 2008 elections in which the U.S. elected Barack Obama to the Presidency and gave Democrats strong majorities in both houses of Congress. The state of the economy forced the newly-elected government to act quickly. Congress passed a $787 billion dollar stimulus plan and the U.S. Treasury, in response to public criticism, prepared new, more stringent rules for companies receiving taxpayer funding under the Emergency Economic Stabilization Act of 2008 intended to enhance transparency, ensure compliance, enforce

accountability, and restrict executive compensation. While the results of these actions will be unknown for many months to come, as we continue into 2009 it has become clear that a quick turnaround is unlikely and that instability and fear still dominate the conversation. Companies are reacting by shedding jobs and lowering forecasts, investors continue to stay on the sidelines, institutional shareholders have become more vocal and powerful as their investments continue to erode, and government intervention and regulation are becoming commonplace.

All of this sets the stage to discuss the topic addressed in this letter: executive compensation. Few issues stir up more controversy, resentment, and debate among investors, executives, board members, politicians, and everyday citizens than executive compensation, especially in a period of economic downturn. Given the significant losses in the stock market and the magnitude of the government intervention with taxpayer dollars, investors and taxpayers are insistent, and rightfully so, that the executives hired to manage their investment are aligned with their interests and financial outcome. The result is a laser-like focus on executive compensation that is causing executives and directors alike to rethink the basic foundation of executive pay.

WHAT SHOULD COMPANIES AND BOARDS BE THINKING ABOUT NOW?

There is no question that the landscape of executive compensation is changing. Some changes are very apparent such as the TARP restrictions on pay at certain financial institutions, while others are yet to be fully understood. What is clear is that the decisions facing companies and boards today will go a long way towards reshaping executive compensation for years to come. So, what are companies thinking about now and what should they be considering longer-term?

In the Short Term (2009 & 2010)

Reactions to Current Market Conditions

The market for executive compensation is embarking on a self-correction period that is likely to be played out over the next two to three years. Similar to the housing market, compensation levels have experienced tremendous growth over the last ten years driven to a large degree through the use of highly leveraged long-term incentive vehicles. Companies saw the use of stock options as an effective and, until 2006, expense-free way to align the executive's interests with the shareholder. Growth bred growth, and a rising tide lifted all boats. Times have clearly changed and, like the housing market, we are now likely to see executive compensation levels decline in the short-term and stabilize over the longer-term at reduced levels.

Given the need to make compensation decisions and approve new long-term incentive ("LTI") awards early in 2009, companies and their compensation committees have already started the self-correction process. In many instances, these decisions have been made without reliable market data. Data provided in compensation surveys and proxy statements have always been a primary tool companies use to provide directional guidance on pay levels. This approach to benchmarking compensation levels is effective during times of relative stability in the markets. Clearly we are far from relative stability and the use of market data is far less reliable and perhaps, at least in the short-term, obsolete. Companies need access to data in real time and cannot afford to wait until summer when surveys are published or until spring when proxies are released detailing year old (2008) compensation decisions. So, without reliable market data and faced with external and internal pressure to react to deteriorating performance and stock prices, companies and compensation committees are making compensation decisions that, over the short-term, may play out as follows:

- Base salary growth will be negligible while many companies freeze salaries for a year or two, and a small minority will even temporarily decrease base pay
  - One exception may exist within the financial services industry where base salaries may actually increase due to pay restrictions imposed by TARP and continued de-leveraging of pay from variable (incentives) to fixed (base salaries)
- Annual incentive plans will likely pay out significantly below target based on company performance, but target opportunities will remain stable
- The primary factor contributing to declines in the overall total compensation level of executives are decreases in the grant value of LTI
- Companies have fallen into two categories when making decisions on LTI values: lead or lag
  - Leading companies have been among the first to make a change to LTI levels and, as data come in, will likely decrease LTI values by 10-20%, for two reasons:
    - They do not have enough available shares to continue to grant similar levels of value as previous years and are hesitant to go to shareholders to ask for additional shares and/or,
    - As a reaction to poor company performance and sharper stock price declines
  - Lagging companies have had the luxury of granting similar value because they have enough shares available to grant, and therefore can afford to do so for a year while waiting on more definitive data to help guide future decisions
- Fast forward to one year from now when data are fully available that reflect the decreases implemented by those "leading" companies and it is very likely that companies who could afford to grant normal LTI awards in 2009 will now find the market data have gone down. The "lagging" companies will likely follow that data down in 2010
- As a by-product of this self-correction, those companies that maintained a premium pay philosophy (75th percentile) could, over the next few years, find themselves at the top of the pay picture

Similar to the way that growth bred growth during the boom years, declines in LTI values will breed further declines as companies react to current performance conditions and to the decisions of their peers. If this scenario were to play out on a broad scale, the gains brought on by the rising tide of executive pay over the last ten years could be significantly reduced within the next two or three years.

Compensation Design Considerations

The monumental drop in the equity markets and rapidly slowing economy has turned LTI programs on their head. Underwater stock options, failed performance plans, and restricted stock with diminished retentive value are forcing companies to re-evaluate the very plans that have traditionally provided the incentives needed to attract, retain, and motivate key talent. While it is expected that companies and compensation committees will be giving significant thought to more permanent plan design alternatives, it is likely that many companies will consider interim design changes to their LTI plans to address retention concerns, manage share usage, and react to poor performance. Others will wait for more concrete data to become available, assess the prospects for new legislation and regulation, and wait for market volatility to calm.

The following list provides insight into the types of questions companies and their compensation committees are asking as they try to react to the current turbulent environment in executive compensation:

- Should we pay a bonus that was technically earned in light of the negative optics of a severely depressed stock price?
- Given the significant decrease in our stock price, how do we balance the delivery of constant value year-over-year verses the resulting dilution caused by having to grant more shares?
- For the next couple of grant cycles, should we be managing to a capped run-rate in order to manage shares available instead of a grant value?
- If we grant stock options at historically low stock prices, do we risk delivering windfall profits if the markets recover but not due to any specific actions of our executive team?
- Why should we deliver the same target LTI value in light of poor financial performance?
- Should we incorporate more time-based restricted stock into the program to help address retention concerns?
- Given the difficulty setting three-year targets in today's environment, should we use a one- or two-year performance period and add a long-term holding requirement on any earned shares (i.e. hold through retirement)?
- If a one-year performance period is used, what are the pros/cons of using the same performance measure as the annual incentive plan?
- If we feel that a three-year performance period is still necessary, do we have confidence to continue with a relative performance measure like TSR or EPS growth?
- What degree of confidence do we have in our ability to set an internal absolute performance goal?
- No matter what type measure is used, should we consider expanding the performance range around target to account for uncertainty in the goal setting process? If so, should the payout range be adjusted (reduced) inward to account for an increased possibility of achieving a payout due to the larger performance range?
- Should we address non-compliance with our stock ownership guidelines, or view this year as an anomaly and revisit the program next year?
- Should we be considering an underwater stock option exchange and what form should it take?
- How will RiskMetrics and other investors/advisors view and vote on any changes that are made in light of the current financial environment?

<u>In the Long Term (2010 & Beyond)</u>

It is understandable if there is limited desire to begin thinking about longer-term approaches to executive compensation; there is plenty to do right now. But like it or not, the ideas that seemed to keep coming up in conversation but never in reality are rapidly becoming more visible though the windshield as the road bends ahead. Concepts like say-on-pay, clawbacks, pay caps, and hold-till-retirement are increasingly prominent in the world of executive compensation, and it is better to begin discussing these ideas now instead of potentially having them forced on you, as occurred in the financial industry. By discussing the list of topics outlined below, companies and compensation committees can get out ahead of the impending push to transform compensation and will be in a better place to take a leading position in the new landscape ahead.

Say-on-Pay

For TARP participants who filed a proxy after February 17, 2009, a non-binding say-on-pay vote is required for inclusion in the 2009 proxy. Many speculate that the new administration will push legislation mandating say-on-pay voting for all companies. Companies should begin discussing how this might be accomplished and perhaps follow the lead of these companies that have set a date for the voluntary adoption of nonbinding say-on-pay voting:

Company	Vote Year	Company	Vote Year
Aflac	2008	Ingersoll Rand	2009
H&R Block	2008	Intel	2009
Jackson Hewitt	2008	MBIA	2009
Littlefield	2008	Motorola	2009
Risk Metrics	2008	Par Pharmaceutical	2009
Zale	2008	Tech Data	2009
Blockbuster	2009	Verizon	2009
Hewlett-Packard	2009	Occidental Petroleum	2010

Clawback Provisions

Clawbacks have already made their way into the programs of many large companies and are required for certain employees at companies receiving TARP assistance. It seems inevitable that clawback requirements will extend to other companies either by law or by best practice. Companies should begin a dialog with internal and external counsel to address how clawback provisions would apply and how they would interact with existing employment agreements and contracts.

Annual Risk Assessments

Another product of recent legislation, annual risk assessments are required of compensation committees of financial institutions receiving government aid through TARP to determine if the incentive plans encourage excessive and unnecessary risk. Many forecast that all public companies may be subject to such mandates in the near future. An annual risk assessment should be considered a normal part of the compensation committee's annual calendar.

Understanding Moral Hazard

The concept of moral hazard (when a party is insulated from risk, it may behave differently than if it were fully exposed to that risk) definitely applies to executive compensation. It is vital that boards understand moral hazard in order to design incentive plans that do not encourage excessive and unnecessary risk. We issued an alert letter on October 10, 2008 (available at www.fwcook.com) that answers two key questions about moral hazard: What does this phrase mean? And more importantly, how can all private sector boards (not just financial firms receiving federal assistance) consider moral hazard in designing their executive annual cash and long-term equity incentive plans?

Modifications to Severance Agreements

Severance arrangements, if appropriately designed, still have a meaningful place in executive compensation. That being said, there is perhaps no bigger target of public outrage and ire than the concept of a golden parachute. Boards need to first understand the various elements of their company's severance policies. The boards should then determine any areas that may be considered poor practice and begin a dialog with legal counsel and the affected executive to negotiate a more appropriate severance arrangement. The chart below identifies several poor severance practices and potential ways to address:

Poor Severance Practice	Potential Modification
Excise tax gross-ups	Eliminate gross-ups or reduce the benefit to $1 below base amount to avoid such tax
Allowing severance for failure or poor performance	Create a bifurcated severance model that would pay no or a limited severance for terminations relating to failed performance
Accelerated vesting of unvested equity upon change-in-control ("single trigger")	Require both a change-in-control and termination of employment to occur before acceleration of vesting ("double trigger")
SERP enhancements (additional age and service credits)	Eliminate any enhancements
"Evergreen" or automatic renewals of employment agreements in perpetuity	Incorporate sunset provisions that would reduce or eliminate severance benefits for those executives with long tenure or significant wealth accumulation
Liberal change-in-control definitions	Amend change-in-control definition such that severance and other benefits would only be provided upon the consummation of a change-in-control and termination of employment ("double-trigger")

Perquisites

Given the continuing negative publicity attracted by executive perquisites (recent incidents have involved office remodeling & corporate aircraft) boards need to be fully aware of the perquisites, and any corresponding tax gross-ups, being offered to executives and must be prepared to defend and rationalize their existence.

Long-Term Shareholder Alignment

Some companies have been criticized for utilizing incentive plans that do not align the long-term interests of executives with those of shareholders. Critics argue that executives reap enormous benefit based on risky decisions that pay off in the short-term but are not held accountable if those bets go bad over a longer period of time. There are a number of ways to address this issue of long-term alignment. Companies can require that all or a portion of all vested, earned or exercised LTI grants be held and not sold until retirement or beyond. Companies can "bank" a portion of the annual bonus and make the banked portion subject to reduction if any inaccuracies (write-downs, bad investments) subsequently arise in the year that the bonus was earned.

Stock Options – Still Relevant?

The recent financial crisis and 2006 changes to accounting rules have greatly exposed the inefficiencies and drawbacks associated with stock options. The appeal of stock options took a hit in 2006 when the Financial Accounting Standards Board required companies to expense stock options in their financial statements. The financial crisis is also taking its toll on the perceived value of stock options. As mentioned earlier, companies and households alike are re-evaluating acceptable leverage and risk. Stock options, arguably the most highly leveraged compensation tool, have not escaped criticism for their role in this crisis. Furthermore, given the precipitous decline in the stock market, option holders are walking around with worthless currency because the options are underwater. These underwater options are still carrying an expense that cannot be reversed by the company while providing no retention and/or motivational benefits to employees. This scenario highlights the inefficiencies associated with stock options and is causing many companies to seek alternatives. One such alternative developed by Fred Cook, Market Stock Units, is briefly described below.

Market Stock Units

A possible replacement for stock options in mature companies: market-leveraged stock units or "MSUs." They are an outright grant of restricted stock units with a long maturity. At the maturity date the number of shares earned and paid is the number of MSUs granted times the ratio of the fair market value at the maturity date to the fair market value at the grant date, subject to a cap of 200%.

Thus, if the stock price goes up, the result is an increase in the shares earned, up to 200% earnout, at an increased stock price. And conversely, if the price declines, the result is a decrease in the shares earned at a decreased stock price.

The problem of single-day pricing that bedevils stock options is solved by using an averaging of prior period stock prices at both the grant date and the maturity date.

The MSU gives up the flexibility inherent in options of being able to choose the exercise date. But this stock option flexibility comes at a high price in inequitable outcomes and the risk of seeing option gains evaporate because the options are held too long.

APPENDIX: SUMMARY OF FREDERIC W. COOK & CO. ALERT LETTERS

This appendix is intended to provide only the highlights and key issues associated with regulatory and legislative developments in executive compensation in 2008 and into 2009. The specific details may be found in the related "alert" letters listed at the end of this memo and are accessible via our web site at www.fwcook.com.

New IRS Section 162(m) Ruling

In a reversal of previous guidance, on February 21, 2008, the IRS issued Revenue Ruling 2008-13, which provides that compensation will not be treated as performance-based under Section 162(m) if it is payable, regardless of actual performance (i.e. at target), in the event of termination (other than due to change-in-control, death or disability) of employment by:

- The company without "cause"
- The employee with "good reason"
- The retirement of the executive

The loss of treatment as performance-based compensation (and the loss of tax deductibility if the covered employee's total compensation for the year in which the compensation is deductible exceeds $1 million) applies to all years, not just the year in which termination of employment occurs.

If the termination of employment provision is in a standard form of award agreement, an incentive compensation plan or a severance plan, it is likely that all payments under the incentive compensation plan would cease to qualify as performance-based compensation under the Revenue Ruling. If, on the other hand, the provision is unique to a single executive (in an award agreement, an employment agreement or a severance agreement), the company would presumably be able to take the position that the taint is limited to that executive.

The Revenue Ruling stipulates that the loss of treatment as performance-based compensation will not be applied to compensation for performance periods that began on or before January 1, 2009 or for any compensation paid under the terms of employment contracts effective on February 21, 2008 (disregarding future renewals or extensions, including those that are automatic).

Highlights from the Recent Congressional Hearing on CEO Pay and the Mortgage Crisis

On March 7, 2008, the House of Representatives' Committee on Oversight and Government Reform ("the Committee") held a hearing titled "Executive Compensation II: CEO Pay and the Mortgage Crisis." The hearing examined the apparent breakdown between shareholder interests and the compensation and retirement benefits awarded to three prominent CEOs (Countrywide CEO Angelo Mozilo, former Merrill Lynch CEO Stanley O'Neal, and former Citigroup CEO Charles Prince) whose companies are involved in the mortgage crisis.

Areas of reform or focus that may develop based on issues discussed at this hearing include:

1. Re-examination of the definition of "cause" for termination purposes

Executives are often entitled to cash severance compensation and other benefits upon involuntary termination of employment if such termination is not for "cause." However, the definition of "cause" used in the vast majority of employment agreements does not include poor performance. The question arises whether it should.

2. Increased prevalence of "clawback" features

Several members of the Committee questioned why incentive compensation was tied to the quantity of loans entered into and seemed to totally ignore the quality of those loans. The key question in this regard was should companies have a way to recapture prior compensation when things go wrong? (See "TARP I" and "TARP II" on pages 12-13)

3. Continued pressure to reduce or eliminate perquisites

Perquisites came under attack in the Committee's staff memorandum. In the last year, we have seen an increase in the reduction or elimination of perquisites in response to the 2006 proxy disclosure rules and continued criticism from shareholders about their non-performance-based nature. Continued negative sentiment may reduce companies' willingness to provide any perquisites, especially those that do not strongly support an important business objective.

4. Closer examination of consultant relationships with management

Although this issue was at the heart of the Committee's prior hearing in December 2007, it resurfaced only to a limited extent and was specifically focused on personal use of a consultant by the CEO. The key question in this regard was "why should executives be provided access to consultants at the company's expense in addition to the Committee's consultant?"

5. Deferred compensation plans may draw increased attention

Congress continues to look into deferred compensation programs in an effort to restrict the amount of income that can be sheltered from current taxation. Although clearly not severance, large deferred compensation accounts that pay out at times when company performance may be declining are difficult for shareholders to understand. The payment appears to run counter to the pay-for-performance mantra.

6. Greater scrutiny placed on use of 10b5-1 plans by executives and directors

Rep. Waxman repeatedly questioned whether Mr. Mozilo's stock sales were in the best interests of shareholders. Although the sales were executed under filed 10b5-1 plans, Rep. Waxman drew attention to the fact that Countrywide announced a large share buyback at the same time that Mr. Mozilo entered into his plan to sell shares.

7. Increased use of retention ratios and ownership guidelines

The vast majority of Fortune 500 companies have executive ownership guidelines in place. The most common approach is a multiple of salary requiring executives to own a specified value of equity after which they can sell holdings to meet their individual financial diversification needs. Another approach, used by Merrill Lynch and Citigroup, called a retention ratio, requires executives

to retain a specified percentage of any equity awards upon vesting or exercise (e.g., 75% of the net after tax value of their equity holdings) until termination from the company.

8. Elimination of severance for CEO/founders

Mr. Mozilo gave up his right to receive $37.5 million in severance and benefits after being called to testify. However, the Committee raised the broader issue of whether his contract should have contained these provisions in the first place.

Comprehensive Executive Compensation "Reform" Bill Introduced into Senate

On April 15, 2008, Senator Hillary Clinton introduced the **Corporate Executive Compensation Accountability and Transparency Act** (S. 2866), which was referred to the Senate Committee on Finance. While Senator Clinton's bill did not emerge from Committee in 2008, many of the provisions of S. 2866 are likely to resurface under the new Obama administration and Democrat controlled Congress.

The Act provides for six key initiatives:

1. Amends Section 409A of the Internal Revenue Code by placing a $1 million limit on non-qualified compensation that can be deferred in a single taxable year.

2. Amends the Sarbanes-Oxley Act by extending the potential recoupment period for CEO and CFO bonuses, equity compensation, or stock sale profits from 12 to 36 months following the filing of a financial statement that requires restatement.

3. Amends Section 14 of the Securities Exchange Act of 1934 to mandate an annual non-binding shareholder vote on executive compensation.

4. Requires that the SEC establish specific disclosure rules to define "independence" between public companies and their executive compensation consultants and prohibits those consultants from doing any other work for the company.

5. Increases executive compensation disclosure requirements for companies (public or private) with federal contracts.

6. Requires that the SEC mandate the use of the grant date present value of equity awards in lieu of the FAS 123R expense accruals in the Summary Compensation Table of the proxy.

Updated Interpretive Guidance on New Executive Compensation Disclosure Rules

On January 24, 2007, the staff of the SEC issued interpretive guidance on the new executive and director compensation proxy disclosure rules. The guidance was updated on August 8, 2007 and further updated on July 3, 2008. The new interpretative guidance from the July 3, 2008 report is briefly summarized below. For an overview of all the SEC's interpretive guidance since 2007 please see FWC's Alert Letter from August 31, 2008.

Compensation Discussion and Analysis

- When evaluating whether performance targets may be omitted from disclosure, companies must first determine if such disclosure is material to an understanding of compensation paid for the

last completed fiscal year. If not material, no disclosure is required; if material, quantitative performance targets must be disclosed unless the goals involve confidential trade secrets or commercial or financial information, the disclosure of which would result in competitive harm to the company. There is no requirement to disclose quantitative targets for inherently subjective or qualitative assessments, such as "demonstrated leadership"

- When determining whether a company's benchmarking practices need to be discussed and analyzed, "benchmarking" is defined generally as using compensation data about other companies as a reference point to provide a framework for compensation decisions. Benchmarking does not include use of broad-based third-party surveys for more general understanding purposes

- If a compensation consultant plays a material role in the company's compensation-setting practices and decisions, then discussion and analysis of that role is required in the CD&A (in addition to the required disclosure of any compensation consultant involvement in the compensation committee governance disclosures)

Summary Compensation Table

- If the rules do not specifically limit footnote disclosure to the last completed fiscal year, footnote disclosure for prior reported years is required only if material to an understanding of compensation for the last completed fiscal year

- Cash retention bonuses that are conditioned on future services are not reported in the bonus column until the fiscal year in which they are earned

- Compensation cost for stock and option awards may be reversed only to the extent such cost was previously reported in the Summary Compensation Table; that is, compensation cost recognized prior to the effective date of the disclosure rules or becoming a named executive officer should not be reversed. However, for purposes of determining the three most highly paid named executive officers, all amounts reversed during the last completed fiscal year are taken into consideration, regardless of whether such amounts were previously reported in the Summary Compensation Table

Outstanding Equity Awards at Fiscal Year End Table

- It is permissible to add a grant date column to the table and a related footnote detailing the vesting schedule that relates to that grant, provided that if a different vesting schedule applies to any award the table must include disclosure about that vesting schedule

Nonqualified Deferred Compensation Table

- Company contributions should include all contributions earned during the last completed fiscal year, even if actually credited to the executive's account in the following year

- Disclosure is required on a plan-by-plan basis for all nonqualified deferred compensation and defined contribution plans

<u>Executive Compensation under the Emergency Economic Stimulus Act of 2008</u>

Troubled Asset Relief Plan ("TARP") I

The Treasury Department under the Bush Administration moved forward rapidly to implement the Emergency Economic Stabilization Act of 2008 (commonly referred to as the "Financial Rescue Plan" and referred to here as "the Act") that was signed into law on October 3, 2008. Instead of implementing the Act through the direct or auction purchase of financial institution assets, initial implementation occurred through the purchase of preferred stock in participating financial institutions, referred to by Treasury as the Capital Purchase Program. In order to participate in the program, the financial institutions had to agree to four sets of compensation restrictions described in Interim Final Regulations promulgated by the Treasury Department on October 14, 2008 that apply to senior executive officers ("SEOs") of participating institutions. The four compensation curbs are:

- Prohibition of incentives that involve "unnecessary and excessive risks";
- Enhanced "clawback" provisions to recoup compensation;
- Prohibition of golden parachute payments in the case of certain severances of employment; and
- New $500,000 limit on tax deductibility of compensation and elimination of "performance-based" exemption.

TARP II

As a reaction to the perceived ineffectiveness of the first TARP program, on February 13, 2009 Congress passed and on February 17, 2009 President Obama signed into law new stimulus legislation (the American Recovery and Reinvestment Act of 2009) that contained numerous changes to the rules regulating the executive compensation arrangements of financial institutions receiving government assistance under the TARP program. The new guidelines apply to all existing and future TARP fund recipients. The significant restrictions now include:

- Prohibition on certain bonus, retention and incentive compensation for senior executive officers (SEOs) and up to 20 other employees;
- Exception for bonuses of up to 50% of base salary (no more than 1/3rd of total annual pay) that must be payable in restricted stock and must only vest after taxpayers have been repaid;
- No cap on base salary;
- Prohibition on golden parachute payments to SEOs and the 5 next most highly-compensated employees;
- Required adoption of a company-wide policy on excessive or luxury expenditures;
- Mandated non-binding "Say on Pay" vote to approve proxy CD&A and related disclosure tables (starting in 2009 for proxies filed after February 17th);
- Direction to the Secretary of the Treasury to review bonus, retention and other compensation paid to SEOs and the next 20 most highly-compensated employees of companies that received TARP assistance prior to the Act;
- Prohibition on incentives that involve "unnecessary and excessive risks";
- Required "clawback" provisions to recoup bonus, retention and incentive compensation for SEOs and up to the next 20 most highly-compensated employees;
- Prohibition on any compensation plan that would encourage manipulation of earnings to enhance compensation;
- Limitation on the tax deductibility of annual compensation of SEOs to $500,000; and

- Requirement of an annual certification by the CEO and CFO of the company's compliance with the restrictions.

On the heels of the passage of the stimulus legislation in February 2009 described above, it was reported that American International Group ("AIG") intended to comply with previously established employment agreements to pay retention bonus payments to employees in their financial products unit totaling $165 million. In reaction to strong public outrage, both the House and Senate quickly passed or proposed several bills that would, depending on the bill, significantly tax any bonus payments made (up to 90%), prohibit any bonus payments until TARP funds are repaid, or impose excise taxes on executive compensation. Many believe (some in Congress included) that the legislation represented an overreaction, intended to put pressure on AIG employees to pay back bonuses, which many did. It is now generally thought that none of the bills, based in part on President Obama's negative reaction, will become law.

RiskMetrics 2009 Policy Updates

Each year RiskMetrics updates its voting guidelines. The 2009 policy updates with regard to executive compensation are broader than in previous years as a response to increased public and shareholder outcry over executive compensation practices.

Pay for Performance Policy

Under its prior policy, RiskMetrics may recommend against an equity plan and/or to withhold votes from compensation committee members if there is a disconnect between CEO pay and company performance, which is defined as: (1) negative total shareholder return ("TSR") over the most recent one- and three-year periods and underperformance of stock price performance vs. the company's six-digit GICS industry group[(1)], and (2) an increase in CEO total compensation. Under the new policy, poor performance is redefined to be one- and three-year TSR in the bottom half of the company's ***four***-digit GICS industry group.

This change is meant to identify the worst performing companies within an industry at a time when broad market declines have affected all industries.

Poor Pay Practices

This is a policy under which RiskMetrics may recommend against or withhold votes from compensation committee members, the CEO, or the entire board if a company has poor compensation practices, which include:

- Egregious employment contracts (e.g., with multi-year pay guarantees)
- Excessive perks
- Abnormally large bonus payouts without justifiable performance linkage or proper disclosure (e.g., changing, canceling or replacing performance metrics during a performance period)
- Egregious pension/SERP payouts (e.g., additional years of service credit)
- Overly generous new CEO hire package (e.g., excessive "make-whole" provisions)

---

(1) GICS refers to the Global Industry Classification System developed by Morgan Stanley and Standard and Poor's.

- Excessive severance and/or change-in-control ("CIC") provisions (e.g., severance greater than 3X cash pay, severance for poor-performance termination, single-trigger CIC severance payouts, perks for former executives)
- Poor disclosure practices
- Internal pay disparity (i.e., between the CEO and other proxy-reported executives)
- Option backdating

The new policy clarifies and expands on the above items as follows:

- Excessive severance/CIC includes any new or amended arrangements that include excise tax gross-ups and/or modified single-triggers (i.e., "walk-away windows")
- Liberal CIC definition such that payments could result without an actual CIC occurring
- Tax gross-ups on any perquisites or other payments
- Paying dividends/dividend equivalents on unearned performance awards
- Guidelines for excessive perks will be personal use of company aircraft greater than $110,000 by an executive in a year or an auto allowance greater than $100,000 for an executive in a year

Examples of good compensation practices are:

- Employment contracts used under limited circumstances for a short period of time (e.g., no automatic renewals)
- Severance formulas not higher than 3X pay and use of historical or target bonus rather than maximum bonus. Also, failure to renew an employment contract, termination under questionable events or termination for poor performance should not be severance triggers
- CIC payments should be made only for a significant change in ownership structure and subsequent loss of job (i.e., "double-trigger"). There should be no excise tax gross-ups or single-trigger acceleration of equity
- Supplemental executive retirement plans ("SERPs") should not include "sweeteners" (e.g., extra service credit or incentive pay – both cash bonuses and equity awards) and pension formulas should be based on average compensation earned, not maximum compensation
- No above-market or guaranteed minimum returns on deferred compensation
- Good proxy disclosure (e.g,. "plain English")
- Trading policies that prohibit executives from hedging company stock holdings or using stock as collateral for loans
- Long-term focus for incentives

Burn Rate Tables

RiskMetrics' tables for its burn rate policy[(2)] were updated compared to prior-year burn rates. Also, stock price volatility will be measured over 400 days rather than 200 days for converting full-value share awards to option equivalents and for its shareholder value transfer ("SVT") plan costing for the December 1, 2008 and March 1, June 1, and September 1, 2009, quarterly data downloads. As

---

(2) If a company's three-year average burn rate exceeds its industry group's mean by more than one standard deviation and is more than 2% of common shares outstanding, ISS will recommend against the company's stock plan proposal even if plan cost does not exceed the allowable cap. A company can avoid a negative vote recommendation by agreeing to a future three-year burn rate of no greater than the higher of 2% or the industry group's mean plus one standard deviation at the time of the commitment.

of December 1, 2009, RiskMetrics intends to return to a 200-day period for measuring stock price volatility.

Seventy-seven percent of industry groups of Russell 3000 companies and 82% of industry groups of non-Russell 3000 companies showed year-over-year increases in their burn rates.

Equity Plan Evaluation - Liberal Definition of CIC

RiskMetrics has quantitative and qualitative criteria for evaluating whether to recommend for or against an equity plan proposal. Under its current policy, RiskMetrics will recommend against a plan if:

- The total cost of the company's equity plans is unreasonable (i.e., SVT exceeds the allowable cap);
- Repricing is expressly permitted without shareholder approval;
- There is a disconnect between CEO pay and company performance and more than 50% of the increase in CEO pay is attributed to equity awards (see previous discussion of this policy);
- The company's three-year burn rate exceeds the greater of 2% and the mean plus one standard deviation of its industry group (see previous discussion of this policy); or
- The plan is a vehicle for poor pay practices (see previous discussion of this policy)

Under its update of this policy, RiskMetrics will recommend against a plan if it includes a liberal definition of CIC such that the plan provides for the acceleration of vesting even though an actual CIC may not occur (e.g., upon shareholder approval of a transaction or the announcement of a tender offer without consummation).

Incentive Bonus Plans and Tax Deductibility Proposals

RiskMetrics' current policy is to recommend in favor of proposals to amend shareholder-approved compensation plans so that they comply with Internal Revenue Code Section 162(m) (162(m) potentially limits the deductibility of compensation awarded to the CEO and the other three highest-paid executives reported in a company's proxy statement unless the compensation is performance-based), if there is no increase in cost. Such amendments include placing a cap on individual grants, adding or re-approving performance goals (unless they are clearly inappropriate), or adding features of an administrative nature. RiskMetrics has added a new item to its current policy, which is to recommend against proposals if the compensation committee does not fully consist of independent outsiders, as defined in RiskMetrics' definition of director independence (i.e., no material connection to the company other than a board seat).

* * * * * * * *

General questions about the subjects in this letter may be directed to Charley King in our Atlanta office at (404) 439-1007 or by email at cyking@fwcook.com, or to Steven Harris in our Atlanta office at (404) 439-1002 or by email at sharris@fwcook.com. Questions regarding specific topics covered in this letter may be addressed directly to the consultant(s) referenced at the end of the related "alert" letters listed below, which may be found along with additional information on our firm and other executive compensation topics, on our Web site at www.fwcook.com.

2008-2009 ALERT LETTERS

01/04/08 SEC ISSUES EXTENSION FOR USING SIMPLIFIED METHOD TO CALCULATE EMPLOYEE STOCK OPTION EXPENSE

02/01/08 A NEED TO REVISIT TERMINATION PROVISIONS - NEW IRS SECTION 162(M) RULING

02/22/08 2007 – THE YEAR IN REVIEW

03/05/08 IRS REVENUE RULING 2008-13 PLANNING CONSIDERATIONS FOR REDUCING LOSS OF TREATMENT AS PERFORMANCE-BASED COMPENSATION UNDER SECTION 162(m)

03/20/08 HIGHLIGHTS FROM THE RECENT CONGRESSIONAL HEARING ON CEO PAY AND THE MORTGAGE CRISIS

05/20/08 COMPREHENSIVE EXECUTIVE COMPENSATION “REFORM” BILL INTRODUCED INTO SENATE

07/14/08 TECHNICAL ISSUES RELATED TO ACCELERATED VESTING OF RSUS AT RETIREMENT

07/31/08 SEC RELEASES INTERPRETIVE GUIDANCE ON NEW EXECUTIVE COMPENSATION DISCLOSURE RULES *(Originally January 29, 2007)*

09/15/08 RECENT DEVELOPMENTS REGARDING THE EFFECT OF EQUITY COMPENSATION ON EARNINGS PER SHARE

10/06/08 CONGRESS CURBS COMPENSATION OF EXECUTIVES UNDER FINANCIAL RESCUE PLAN

10/09/08 SUMMARY OF FASB STATEMENT 123R SHARE-BASED PAYMENT *(Originally April 29, 2005)*

10/10/08 “MORAL HAZARD AND EXECUTIVE COMPENSATION”

10/17/08 TREASURY DEPARTMENT ISSUES EXECUTIVE COMPENSATION RULES UNDER THE CAPITAL PURCHASE PROGRAM FOR U.S. FINANCIAL INSTITUTIONS

11/26/08 RISKMETRICS 2009 POLICY UPDATES

02/18/09 CONGRESS EXPANDS RESTRICTIONS ON EXECUTIVE COMPENSATION FOR FINANCIAL INSTITUTIONS UNDER TROUBLED ASSET RELIEF PROGRAM