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Treasury Issues TARP Guidance on Compensation and Corporate Governance

EXECUTIVE SUMMARY

On June 15, 2009, the long-awaited guidance of the Treasury Department on the compensation restrictions and corporate governance requirements under the provisions of the American Recovery and Reinvestment Act of 2009 (ARRA) applicable to financial institutions receiving assistance under the Troubled Asset Relief Program (TARP)[1] was published in the Federal Register, in the form of an interim final rule.

This letter discusses the provisions of the interim final rule applicable to TARP recipients that received financial assistance under the Capital Purchase Program.[2] The discussion of the extensive provisions of the interim final rule, after explaining who is a "covered employee," is organized into two main topics: (1) the provisions that affect the compensation of covered employees and (2) the provisions that impose structural limits and administrative procedures with respect to executive compensation.

Provisions affecting covered employee:

- Prohibition on paying or accruing any bonus, retention award, or incentive compensation during the period in which any TARP obligation to the Federal government is outstanding (referred to in this letter as the "TARP Period"), subject to an exception for a limited amount of restricted stock that meets certain requirements
- Prohibition on golden parachute payments during the TARP Period
- "Clawback" (i.e., recovery) of any bonus, retention award, or incentive compensation based on materially inaccurate financial statements or performance metrics
- Prohibition on tax gross-ups to during the TARP Period

Provisions imposing structural limits and administrative procedures:

- Rules with respect to the review of compensation plans by a compensation committee consisting solely of independent directors, including the committee's discussion, evaluation and review at least every six months of:
  - — Compensation plans for senior executive officers (SEOs) to ensure that the plans exclude incentives to take unnecessary and excessive risks

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[1] See our letter of February 18, 2009, "Congress Expands Restrictions on Executive Compensation for Financial Institutions under Troubled Asset Relief Program" http://www.fwcook.com/alert_letters/02-18-09_Congress-Expands-Restrictions-on-Executive-Compensation.pdf, which is available at our website at www.fwcook.com.

[2] More extensive compensation rules apply to companies that have received "exceptional financial assistance" (AIG, Citigroup, Bank of America, Chrysler, GM, GMAC, and Chrysler Financial). Those rules are not discussed in this letter.

- Compensation plans for all employees to determine the risks posed to the TARP recipient by the plans and how to limit the risks
- Compensation plans for all employees to ensure the plans do not encourage manipulation of earnings to enhance compensation

- Compensation committee certifications relating to its discussion, evaluation and review of employee compensation plans
- Required adoption of a company-wide policy on excessive or luxury expenditures
- Required disclosures with respect to compensation consultants and perquisites
- Required annual certification by the CEO and CFO of the TARP recipient's compliance with all of the provisions in the interim final rule discussed in this executive summary
- Review by the Secretary of the Treasury of bonuses, retention awards and other compensation paid to covered employees of companies that received TARP assistance prior to February 17, 2009 (the date of enactment of ARRA)

WHO IS A COVERED EMPLOYEE?

Except for the prohibition on bonus payments, the covered employees of a TARP recipient are its SEOs and the applicable number of most highly compensated employees, which depends on the compensation provision.

Who are the SEOs? The SEOs are the named executive officers reported in the TARP recipient's proxy statement. Since under certain circumstances a company can have more than five named executive officers (for example, multiple CFOs during the year), this is a somewhat broader definition than that suggested by ARRA, which refers to the top 5-paid executives reported in the proxy statement.

How are most highly compensated employees determined? The determination is made based on annual compensation for the prior year. This is consistent with the definition of an SEO, which is based on the employee's officer status and compensation in the year prior to the proxy statement. For example, whether someone is a most highly compensated employee for 2009 is based on his or her annual compensation for 2008. (The preamble to the interim final rule notes that the Treasury Department has considered whether the prior-year standard might lead to manipulation (for example, by cycling employees in and out of highly compensated status on an alternate year basis), and invites commentary on whether any modification to the rule is necessary.)

What is annual compensation? The interim final rule provides that annual compensation is the dollar value of total compensation that would be reported in the TARP recipient's proxy statement if the employee were a named executive officer. For this purpose actuarial increases in pension plan values and above-market earnings on deferred compensation are not taken into account (as is the case in determining named executive officers, other than a company's CEO and CFO, for proxy statement disclosure). As a result, annual compensation will likely be very different from taxable income because, for example, it will include the FAS 123R accounting expense for equity compensation whether or not the employee has exercised stock options or is vested in other equity compensation (and thus subject to income tax).

PROVISIONS AFFECTING COVERED EMPLOYEES

Prohibition on Bonus Payments During the TARP Period

What is the prohibition? Absent an exception, during the TARP Period no bonus payment can be paid to or accrued for a covered employee.

Who is a covered employee? For purposes of the bonus prohibition, the degree of financial assistance received by the TARP recipient determines who the covered employees are:

Amount of Financial Assistance	Covered Employees
$500 million or more	SEOs + next 20 most highly compensated employees
From $250 million to less than $500 million	SEOs + next 10 most highly compensated employees
From $25 million to less than $250 million	5 most highly compensated employees
Less than $25 million	1 most highly compensated employee

What is a bonus payment? Compensation is a bonus payment under the interim final rule if it is a bonus, an incentive payment, or a retention award. As recognized by the interim final rule the three categories may partially overlap. A bonus payment may also include the TARP recipient's forgiveness of a loan to an employee or of any other amount that the employee is required to pay to the TARP recipient.

What is a bonus? Bonus is defined as any payment in addition to any amount payable to an employee for services performed at a regular hourly, daily, weekly, monthly, or similar periodic rate. Amounts are excluded if they are contributions to a tax-qualified retirement plan, benefits under a broad-based benefit plan, bona fide overtime pay, and routine expense reimbursements. A benefit plan is any plan that would be a "welfare plan" under ERISA (such as a medical or life insurance plan) and dependent care, tuition reimbursement and cafeteria plans; deferred compensation and severance plans are specifically excluded. The interim final rule notes that a contribution to, or an increase in benefits under, a nonqualified deferred compensation plan may be a bonus.

A bonus does not include commission compensation, provided that the commission rate is pre-established and reasonable and is applied consistently to the sale of substantially similar goods and services. Commission compensation is limited to compensation consistent with a commission program that was in existence on February 17, 2009 (the date of ARRA's enactment), provided that the program covered employees similar to the SEO or highly compensated employee. Additional requirements apply to the extent that the commissions are based on sales to related parties. Compensation received as asset management fees may also qualify as commission compensation under certain circumstances described in the interim final rule. Payments based on the consummation of a specific transaction are excluded from the commission compensation definition.

What is incentive compensation? Incentive compensation is compensation provided under an incentive plan which is defined with reference to the broad definition used for proxy statement purposes, which includes "any plan providing compensation intended to serve as an incentive for performance over a specified period." The interim final rule specifically includes any plan providing equity-based compensation (i.e., stock options, restricted stock and restricted stock units) as an incentive plan, and excludes an arrangement under which an employee earns commission compensation.

Stock payments will not be incentive plan payments as long as the stock (or stock units) is fully vested, is determinable as a dollar amount and accrues at the same time as regular salary. For example, instead of paying an employee $15,000 a month in salary, a TARP recipient could pay the employee $10,000 in cash and credit the employee with stock units worth $5,000. Although the TARP recipient could provide for delayed payment of the stock units, the employee must obtain an immediate vested right to the stock units.

What is a retention award? Consistent with the broad approach of the interim final rule, a retention award is defined as any payment that is (1) not payable periodically to the employee for services performed, (2) contingent on the completion of future service with the TARP recipient, and (3) not based on performance. Excluded from this broad definition are payments to and from tax-qualified retirement plans, benefit plan payments, fringe benefit payments, overtime pay, and reasonable expense reimbursements. Also excluded are employer credits to an account balance-type deferred compensation plan, and benefit accruals under a supplemental retirement plan if the accruals continue under a plan the benefits under which have not been materially enhanced (including enhancement by expansion of the class of eligible employees) for a significant period of time prior to the covered employee's becoming an SEO or most highly compensated employee.

The interim final rule specifies that retention awards include sign-on bonuses with new employees that are subject to repayment obligations if the employee terminates prior to a specified date.

What are the exceptions to the prohibition? There are three exceptions to the prohibition: restricted stock, payments required under employment contracts in effect on February 11, 2009, and payments prior to June 15, 2009.

Restricted Stock. The exception for restricted stock (which includes restricted stock units (RSUs) for this purpose) applies if the following requirements are met:

- The amount of restricted stock granted cannot exceed more than one-third of the covered employee's annual compensation for the year it is granted (including the value of the restricted stock). For this purpose the annual compensation definition (see p. 2) is modified by only taking into account equity compensation in the year of grant, at its full value on the grant date. Annual compensation in 2010 will not include any value attributable to equity grants before 2010, even though the amount taken into account as a FAS 123R accounting expense in 2009 will be included in determining whether the employee is a most highly compensated employee. Similarly, the full value of a restricted stock grant in 2010 will be

taken into account for the purpose of the limit, even though the FAS 123R expense for the restricted stock will be taken into account over several years.

(For example, if a covered employee's annual compensation in 2010 consisted of $600,000 in salary and a restricted stock grant with a value of $300,000 vesting over 3 years, the employee's annual compensation for 2010 is $900,000. The exception is satisfied because $300,000 is one-third of $900,000. The 2010 grant would not be taken into account in determining the 2011 limit on restricted stock granted to the employee.)

- The employee must perform at least two years of service for the TARP recipient in order to vest, subject to exceptions for death, disability, or a change in control, as defined under regulations under sections 280G or 409A of the Internal Revenue Code (IRC). More restrictive conditions are permissible; e.g., a longer vesting period; performance conditions.
- The restricted stock may only become transferable (or payable in the case of RSUs) under a schedule based on the timing of the repayment of the TARP financial assistance. When 25% of the financial assistance is repaid 25% of the shares become transferable; when 50% is repaid an additional 25% becomes transferable; when 75% is repaid another 25% becomes transferable; and upon full repayment all shares become transferable. An exception applies to restricted stock that permits shares to be transferred to pay for tax liabilities triggered by the vesting of the shares.

Employment Contract. The bonus payment prohibition does not apply to payments under a binding employment contract in effect on February 11, 2009. The exception applies to any type of agreement between the employee and the TARP recipient that gives the employee a legally binding right (including an equity award agreement). For example, a grant of stock options on or before February 11 is covered by the exception, even if the options are subject to future vesting conditions. The benefit of this exception is lost if there is any amendment to the employment contract after February 11, 2009 that materially increases the benefits to the employee.

Pre-June 15, 2009 Bonus Payments. A limited exception applies to bonus payments paid or accrued prior to June 15, 2009 (the effective date of the interim final rule). This exception is more restrictive than the employment contract exception since it does not cover the portion of a bonus payment that accrues after June 14. For example, it appears that only the portion of a restricted stock award granted on February 20, 2009 vesting over three years that accrues prior to June 15 would be covered by the exception; the remaining accrual must be reduced if necessary to comply with the restricted stock exception.

Prohibition on Golden Parachute Payments

What is the prohibition? No payment may be made to the covered employees of a TARP recipient on the employee's departure or upon a change in control. The prohibition applies to all amounts that a covered employee is entitled to at the time of departure or a change in control, regardless of when the amounts are actually paid. The prohibition also applies to the acceleration of vesting due to the employee's departure or a change in control, taking into

account the full present value of the payment without regard to the portion of the vesting period that was completed prior to the departure or change in control.

Who is a covered employee? For purposes of the prohibition, the covered employees are the TARP recipient's SEOs and the next five most highly compensated employees, regardless of the amount of financial assistance received by the TARP recipient.

What is a change in control? Under the interim final rule a change in control is defined as an event that would be a change in control under the regulations under IRC section 280G or 409A.

What are the exceptions to the prohibition? The interim final rule provides for the following exceptions to this prohibition:

> Payments for Services Performed or Benefits Accrued. A payment meets this exception if it would be made regardless of whether the employee departs or the change in control occurs, or if the payment is due upon the departure of the employee, regardless of whether the departure was voluntary or involuntary. The exception for payments due upon any departure will apply even if there are some reasonable restrictions on the payment; for example, a payment otherwise due upon departure that will be forfeited if the employee was fired for cause. This exception does not apply to payments from benefit plans and deferred compensation plans, which must meet the terms of the exception described below.
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> Pension Plan Payments. This exception is applicable to payments made under an IRC tax-qualified pension plan or a pension or other retirement plan governed by the laws of any foreign country.
>
> Payments Due by Reason of Death or Disability. This exception applies to any payment made because of the employee's death or disability.
>
> Certain Severance Payments. This exception applies to severance payments required by state statute or foreign law that is generally applicable to all employers within the applicable jurisdiction.
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> Payments from Benefit Plans and Deferred Compensation Plans. See the discussion under "what is a bonus" above for the description of a benefit plan for purposes of this exception. A deferred compensation plan for purposes of this exception is any program under which an employee voluntarily elects to defer compensation, a program under which deferrals are mandated by the TARP recipient, and a supplemental retirement plan. The following requirements must be met in order for a payment from a benefit plan or a deferred compensation plan to not be a golden parachute payment:
>
> - The plan must have been in effect at least one year prior to the employee's departure;
> - Plan amendments increasing benefits in the year before departure cannot be taken into account;

- The employee must have a vested right to plan benefits without regard to the departure or the change in control;
- Benefits must be accrued each period only for current or prior service to the TARP recipient (or a predecessor employer);
- No discretionary acceleration of vesting or benefit accrual must occur within one year before the departure or change in control; and
- With respect to payments under a deferred compensation plan, the TARP recipient must have previously recognized a compensation expense, or set aside funds in a "rabbi trust."

Note that there is no exception for pre-existing severance plans or agreements, or severance provisions in employment agreements.

Clawback (Recovery) of Bonus Payments

What is the clawback requirement? The TARP recipient must ensure that any bonus payment during the TARP Period to a covered employee is subject to clawback (recovery) if it was based on materially inaccurate financial statements or any other materially inaccurate performance criteria. Amounts are subject to recovery if the covered employee receives a legally binding right to the payment during the TARP Period, even if payment occurs after the end of the TARP Period.

If the right to repayment exists, the TARP recipient must exercise its recovery right unless it would be "unreasonable" to do so. The only example in the interim final rule of when it would be unreasonable is if the costs of recovery would exceed the amount recovered.

Who is a covered employee? For purposes of the clawback requirement, the covered employees are the TARP recipient's SEOs and the 20 next most highly compensated employees, regardless of the amount of financial assistance received by the TARP recipient.

What are the repayment standards? If a covered employee knowingly provided inaccurate information, repayment is required in all cases. For all other covered employees the repayment obligation depends on whether the actual performance or accurate application of the actual performance to the performance criteria is materially different from the performance required under the performance criteria or the inaccurate application of the actual performance to the performance criteria.

Prohibition on Tax Gross-Ups During the TARP Period

What is the prohibition? During the TARP Period no tax gross-ups may be provided to any covered employee, even if payment occurs after the end of the TARP Period.

Who is a covered employee? For purposes of this prohibition, the covered employees are the TARP recipient's SEOs and the 20 next most highly compensated employees, regardless of the amount of financial assistance received by the TARP recipient.

What is a tax gross-up? The interim final rule defines it as any reimbursement of taxes owed with respect to any compensation, except for certain tax equalization payments made to compensate employees subject to foreign taxes in excess of United States taxes.

PROVISIONS IMPOSING STRUCTURAL LIMITS AND ADMINISTRATIVE PROCEDURES

Evaluation of Compensation Plans by Compensation Committee

What compensation plans are covered? The interim final rule provides that the evaluation applies to any employee compensation plan, which is defined as any plan or arrangement involving more than one employee pursuant to which cash or other benefits may be paid.

Who must perform the evaluation? The evaluation is to be made by the compensation committee of the TARP recipient consisting solely of independent directors. For companies that do not have securities registered under the federal securities laws this review can be conducted by the board of directors.

What are the requirements for the compensation committee? The following requirements are applicable to the compensation committee's review of employee compensation plans:

- The committee must discuss, evaluate and review every six months with the TARP recipient's senior risk officers the compensation plans for SEOs to ensure that the plans do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the TARP recipient;
- The committee must discuss, evaluate and review every six months with the senior risk officers all employee compensation plans "in light of the risks posed to the TARP recipient by such plans and how to limit such risks;"
- The committee must discuss, evaluate and review every six months all employee compensation plans to ensure that these plans do not encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of any of the TARP recipient's employees;
- The committee must provide a narrative description once per year of (1) how the SEO compensation plans do not encourage the SEO to take unnecessary and excessive risks that threaten the value of the TARP recipient, (2) the risks posed by employee compensation plans and how those risks were limited, and (3) how the TARP recipient has ensured that its employee compensation plans do not encourage the manipulation of reported earnings to enhance the compensation of any of its employees; and
- The committee must certify the completion of the reviews described above.

In order to conduct the first two reviews the committee must discuss and evaluate with the TARP recipient's senior risk officers any short-term or long-term risks that could threaten the value of the TARP recipient. The committee must identify the features in the SEO compensation plans that could lead the SEOs to take these risks and the features in the employee compensation plans "that pose risks to the TARP recipient, including any features in the SEO compensation

plans and the employee compensation plans that would encourage behavior focused on short-term results and not on long-term value creation." The committee is required to "limit these features to ensure that the SEOs are not encouraged to take risks that are unnecessary or excessive and that the TARP recipient is not unnecessarily exposed to risks."

Note that the required evaluation extends to all of the TARP recipient's employee compensation plans, not just plans covering SEOs. Especially with large TARP recipients, this review process could encompass hundreds of plans, many, if not most, of which have not previously been reviewed by the committee. Developing the necessary procedures to conduct these reviews is likely to prove challenging.

Where must the required narrative be provided? The committee's required narrative is to be provided as part of the Compensation Committee Report in the proxy statement. The interim final rule provides that the Compensation Committee Report must identify each employee compensation plan maintained by the TARP recipient, and provide information demonstrating compliance with the requirements described above.

Where must the required certification be provided? The required certification that the committee has complied with its obligations under the interim final rule is also to be part of the Compensation Committee Report. The interim final rule contains a form of certification that can be used to satisfy the certification requirement.

Adoption of Company-Wide Policy on Excessive or Luxury Expenditures

What is the requirement for adoption of the policy? The board of directors of a TARP recipient must adopt a policy with respect to excessive or luxury expenditures. The policy must be adopted by September 14, 2009 in the case of current TARP recipients and by 90 days after the closing date of the agreement between the TARP recipient and the Treasury Department for companies that first become TARP recipients after June 15, 2009.

What are excessive or luxury expenditures? They are defined as the following, unless the expenditure can be justified as reasonable expenditures for staff development, reasonable performance incentives, or other similar reasonable measures conducted in the normal course of the TARP recipient's business operations: (1) entertainment or events, (2) office and facility renovations, (3) aviation or other transportation services, and (4) other similar items, activities, or events.

What must the policy contain? The interim final rule provides that six items must be contained in the policy:

- Identification of the types of categories or expenditures that are prohibited;
- Identification of the types of categories or expenditures for which prior approval is required;
- Reasonable approval procedures;
- A requirement that the CEO and CFO certify that approvals were properly obtained in the case of expenditures requiring approval by executive officers or the board of directors (or a committee of the board);

- A procedure for reporting violations; and
- Procedures mandating accountability for adherence to the policy.

Disclosures Regarding Compensation Consultants and Perquisites

The interim final rule introduces two new disclosure requirements, one applicable to compensation consultants and the other to perquisites. Each requirement is satisfied by providing the required disclosure to the Treasury Department and the TARP recipient's primary regulatory agency.

What is the required disclosure relating to a compensation consultant? The compensation committee must annually provide a description of whether the TARP recipient, its board of directors, or the committee has engaged a compensation consultant. The disclosure must describe all services by the consultant or its affiliates to the TARP recipient, its board of directors, or the committee over the preceding three years, including any benchmarking employed "to identify percentile levels of compensation." As an example relating to benchmarking, the interim final rule refers to disclosures regarding the entities used for benchmarking, the justification for using those entities, and "the lowest percentile level proposed for compensation."

What is the required disclosure relating to perquisites? The TARP recipient must disclose any perquisite whose value exceeded $25,000 for each of the covered employees subject to the bonus prohibition. In addition to describing the perquisite and its recipient, the disclosure must provide a justification for offering the perquisite.

Other TARP Requirements

The interim final rule discusses briefly, but provides no additional guidance with respect to, two other ARRA requirements: IRC section 162(m)(5) and a mandatory say on pay vote.

IRC Section 162(m)(5). Under this section all TARP recipients are automatically subject to IRC section 162(m)(5), which imposes a $500,000 annual limit on the compensation that can be deducted with respect to each SEO during the TARP Period.[3]

Mandated "Say on Pay" Vote on Executive Compensation. The interim final rule reaffirms the requirement of an annual shareholder vote to approve the compensation of executives, but offers no additional guidance. Instead, TARP recipients are directed to SEC guidance with respect to the standards to be followed in complying with this obligation. SEC guidance with respect to this requirement is currently located at http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm.

[3] For a discussion of current IRS guidance with respect to IRC section 162(m)(5) see our letters 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; 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

Certification by CEO and CFO

The TARP recipient's CEO and CFO must certify that the company has complied with the compensation and corporate governance obligations described in the interim final rule. The certification is generally to be filed as an exhibit to the TARP recipient's annual report on Form 10-K. The required certifications are extremely detailed and the interim final rule contains sample certifications that cover sixteen different areas.

Review of Bonuses, Retention Awards, and Other Compensation Paid to Covered Employees Prior to February 17, 2009

As has been widely reported, the Treasury Department has established the Office of the Special Master for Executive Compensation and appointed Kenneth R. Feinberg as the Special Master. The Special Master has been given the authority to determine whether any payments paid before February 17, 2009 (the date of ARRA's enactment) to employees of TARP recipients that received financial assistance prior to ARRA were inconsistent with purposes of ARRA, or otherwise contrary to the public interest. If the payments are inconsistent, the Special Master is directed to negotiate with the TARP recipient and the employee to seek reimbursement to the Federal government. This look-back ability is not limited to employees subject to the bonus payment limitations, but appears to extend to all employees of the TARP recipient.

The interim final rule does not contain specific guidance as to how to determine whether overpayments have been made, but lists six general principles that the Special Master is to take into account, including the TARP recipient's need to pay competitively; the need for an appropriate allocation of compensation between salary, short-term, and long-term compensation; the general need that a significant portion of compensation for senior executives be long-term compensation; and the need for an appropriate portion of the compensation to be performance-based. One cannot help but notice that these general principles are difficult, at best, to reconcile with the compensation philosophy embodied by the bonus payment limit that applies to post-ARRA compensation.

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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.