TREASURY ANNOUNCES NEW RESTRICTIONS ON EXECUTIVE COMPENSATION

On February 4, 2009, the United States Department of the Treasury (Treasury) issued a new set of guidelines on executive compensation for financial institutions that receive government assistance. Most of the new standards will not apply retroactively to existing government investments and assistance programs, such as the Capital Purchase Program (CPP) established pursuant to the Troubled Asset Relief Program (TARP) of the Emergency Economic Stabilization Act of 2008 (EESA), and the Term Asset-Backed Securities Loan Facility (TALF), a funding facility established by the Federal Reserve. In its press release, Treasury stated that the new guidelines are designed to "ensure that the compensation of top executives in the financial community is closely aligned not only with the interests of the shareholders of financial institutions, but with the taxpayers providing assistance to those companies."

The new guidelines distinguish between institutions participating in any new generally available capital access programs, such as the recently announced Capital Assistance Program of the Financial Stability Plan, and those needing "exceptional assistance." Institutions that are subject to the "exceptional assistance" standard are those that have specific negotiated agreements with Treasury. Examples would include AIG, Bank of America, and Citigroup.

The following is a summary of the new guidelines.

I. ENHANCED CONDITIONS ON EXECUTIVE COMPENSATION

A. Executive Compensation Conditions for Institutions Participating in New Generally Available Capital Access Programs

Treasury has strengthened its executive compensation provisions for recipients of government support under any new, generally available capital access programs. It has stated that it intends to issue proposed guidance subject to public comment on the following:

- **Senior Executive Compensation Limits–US$500,000.** The new guidelines state that companies that participate in new, generally available capital access programs must limit senior executives to US$500,000 in total annual compensation plus restricted stock. However, a company may waive these guidelines by disclosure of its compensation and, if requested, a non-binding

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"say on pay" shareholder resolution. Unlike the CPP, which requires companies to review and certify that the top five executives' compensation arrangements do not encourage excessive and unnecessary risk-taking, companies participating in new capital access programs must conduct such a review and provide disclosure with respect to both senior executives and "other employees."

- **Clawback Provisions**. Under existing government assistance programs such as the CPP, only the top five senior executives are subject to a "clawback" provision to recapture a portion of bonuses and incentive compensation. The new guidelines require a company receiving government assistance to have in place provisions to also claw back bonuses and incentive compensation from the next 20 senior executives if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay. The new guidelines do not appear to require that the information be "materially" inaccurate for the clawback provision to apply.
- **Golden Parachutes.** Upon severance from employment, any of the top five senior executives of a company will not be allowed to receive a golden parachute payment exceeding one year's compensation—a more stringent requirement than the three-year compensation limit under the CPP.
- **Luxury Expenditures.** The board of directors of a company receiving government assistance under a generally available capital program must adopt a company-wide policy on any expenditures related to aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events, and post the text of such policy on the company's website. In addition, a chief executive officer must certify all expenditures that could be viewed as excessive or luxury items.

B. Executive Compensation Conditions for Companies Receiving Exceptional Assistance

- **Senior Executive Compensation Limits–US$500,000.** The new guidance limits the total amount of compensation that a senior executive may receive to US$500,000 (not including restricted stock awards), while existing programs providing exceptional assistance to financial institutions only prohibit recipients of government funds from taking a tax deduction for senior executive compensation above US$500,000. Under the new guidelines, any pay above the US$500,000 limit must be made in restricted stock or other similar long-term incentive arrangements. A senior executive receiving restricted stock will be permitted to sell such stock only after the government has been repaid—including the contractual dividend payments that ensure that taxpayers are compensated for the time value of their money—or after a specified period according to conditions that consider, among other factors, the degree a company has satisfied its repayment obligations, protected taxpayer interests, or met lending and stability standards.
- **"Say on Pay" Shareholder Resolution.** The senior executive compensation structure and an explanation for how compensation is tied to sound risk management must be submitted to a non-binding shareholder vote. Existing programs do not contain any such "say on pay" provisions.
- **Clawback Provisions.** Under existing programs providing exceptional assistance, only the top five senior executives were subject to a clawback provision. Any company receiving exceptional assistance in the future must have in place provisions to also claw back bonuses and incentive compensation from any of the next 20 senior executives if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay.

- **Golden Parachutes.** The existing programs providing exceptional assistance to financial institutions prohibited the top five senior executives from receiving any golden parachute payments upon severance from employment. Treasury has stated that it will expand this prohibition to include the top ten senior executives of an institution receiving exceptional assistance. In addition, the new guidelines prohibit, at a minimum, the next 25 executives from receiving any golden parachute payment exceeding one year's compensation upon severance from employment.
- **Luxury Expenditures.** The board of directors of a company receiving exceptional assistance must adopt a policy relating to the approval of luxury expenditures. This new requirement is the same as the requirement for companies accessing new, generally available capital programs described above.

II. LONG-TERM REGULATORY REFORM

Treasury has announced the need for long-term regulatory reform in order to align compensation strategies with proper risk management and long-term value and growth. Proposed compensation strategies would apply at all levels of an institution and not solely to executives. Public companies would be required to review and disclose employee compensation arrangements to ensure that employees' pay promoted sound risk management and long-term value creation, not unnecessary risk-taking for short-term profit. Compensation for top executives would be designed to encourage long-term perspectives on the creation of value for both shareholders and the economy at large. Non-binding "say-on-pay" shareholder resolutions would be encouraged for executive and organization-wide compensation plans. A conference bringing together various interested parties from the public, private, and academic arenas would be hosted by Treasury to develop models for "best practices" with respect to corporate compensation. If followed, this proposal has the potential to profoundly impact the way in which companies in the United States—both those receiving bailout funds and others—compensate employees at all levels.

III. PENDING LEGISLATION

New legislation regarding executive compensation has been introduced in Congress. The Senate passed two bills, introduced by Senators Claire McCaskill (D-MO) and Chris Dodd (D-CT), that would take much of what Treasury has set forth in its guidelines, strengthen it in parts, and codify it as law. The House has not yet taken up consideration of these proposals.

Senator McCaskill's bill lowers to US$400,000 (or, more precisely, the salary of the US President) the cap on executive compensation for institutions receiving funds under the TARP, removes any exceptions to the cap, and makes it applicable to *all* employees of the institution. Whereas the Treasury plan sets the cap at US$500,000 and provides some allowances for bonuses or other incentive compensation, the McCaskill bill makes no such exceptions.

Senator Dodd's amendment to the EESA repeats and codifies as law some aspects of the Treasury guidelines while strengthening other aspects of it. The Dodd amendment adds a blanket prohibition on the payment of bonuses or similar incentive compensation to the top 25 most highly paid employees at a TARP-recipient firm (or more if the Secretary deems it appropriate) while TARP funds are outstanding, and requires a lookback review by the Secretary of all bonus awards paid to executives of current TARP recipients to determine whether any amounts need to be repaid to the government. Also, in some cases the restrictions in the Dodd amendment would reach deeper into executive ranks than the Treasury plan. The Secretary would be charged with promulgating regulations to implement the Dodd amendment's restrictions.

IV. COMPLIANCE AND CERTIFICATION

The chief executive officer of any institution that has received government assistance or will receive such assistance must provide certification that the company has strictly complied with all applicable statutory, Treasury, and contractual executive compensation restrictions.

This new standard does not supplant the requirement that the compensation committee of a company receiving government assistance must provide an explanation of how its senior executive compensation arrangements do not encourage excessive and unnecessary risk-taking.

V. IMPLICATIONS OF NEW EXECUTIVE COMPENSATION RESTRICTIONS

With both public policy and public opinion placing great emphasis on curbing the perceived excesses of executive compensation, careful compliance with the Treasury guidelines will be critical for the foreseeable future. Institutions should begin contemplating how to align compensation structures with long-term growth goals and should give consideration to what corporate-governance changes will be necessary to properly establish and oversee the new compensation programs.

We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney, or:

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