Client Alert

February 6, 2009

The Ever-Changing Federal Assistance Landscape: Treasury's New Executive Pay Restrictions

Outrage over Wall Street bonuses has prompted the Treasury Department to impose a new round of limitations on executive compensation programs at financial institutions taking government funds. Communicated in a February 4, 2009 press release issued by Treasury, the rules are subject to public comment and expected to be finalized within weeks.

The new rules are considerably more restrictive than those previously imposed on institutions that have received government funds and are to be applied prospectively. Treasury has indicated its goal is to better align executive compensation at these organizations with shareholder and taxpayer interests by:

- Imposing a $500,000 cap on cash compensation to executives
- Restricting equity compensation to restricted stock tied to repayment of government debt
- Further limiting severance payments
- Expanding clawback requirements for inappropriate incentive payments
- Requiring a Board-approved and disclosed policy on luxury expenditures

The guidelines create two separate programs: one for healthy institutions – the Generally Available Capital Access Program (GACAP) – and another for institutions needing "exceptional assistance" – the Exceptional Financial Recovery Assistance Program (EFRAP).

> ***PM&P Observation:*** Significantly, Treasury's press release hinted at legislative reform on the horizon that would apply to all public companies, regardless of whether they receive federal assistance, which would parallel some of these restrictions.

The Generally Available Capital Access Program

This more widely available aid program is intended to provide necessary credit toward the recovery of the financial system as a whole by providing capital to smaller community banks, among other institutions, that play a critical role in lending to small businesses and families. The terms and conditions of assistance are generally the same from company to company, with limits on the amount each institution can receive and specified returns for taxpayers. Although Treasury indicated that the previously established Capital Purchase Program (CPP) is an example of a GACAP, participants in the CPP are not subject to these GACAP restrictions.

Institutions participating in the GACAP will be subject to the following executive compensation rules:

- **Senior Executives are limited to $500,000 in Total Annual Compensation (other than Restricted Stock):** The Senior Executive Officers (SEOs – usually the top five officers) are prohibited from receiving annual cash compensation in excess of $500,000. This restriction is in addition to the $500,000 tax deduction limitation imposed on the compensation of the SEOs.

- **Restricted Stock Cannot Vest Until Government is Repaid:** Companies may issue stock or other similar long-term incentives in addition to the annual $500,000, but executives cannot realize value from the award until the government has been repaid including interest or dividends (or after certain conditions related to satisfactory repayment obligations or other taxpayer interests have been met).

However, in an important exception, both of the above limitations will be waived if the compensation is disclosed and, if requested, a non-binding "say on pay" resolution is submitted for shareholder approval.

> ***PM&P Observation:*** This critical exception appears to be a stealth mandate on "say on pay." The limits are potentially so onerous that any organization subject to such limits will probably aim to qualify for the exception.

- **Mandatory Risk Assessment for All Executive Incentives:** Participating firms must review and disclose why compensation arrangements for senior executives and other employees do not encourage excessive and unnecessary risk taking. Under the CPP, companies had only to review and certify that the SEOs' compensation arrangements did not encourage such risk.

- **Clawback Provisions for Top 25:** A company must have the means to recover any incentive payments made to SEOs and the next twenty highest executives who are found to have knowingly provided inaccurate information related to the financial statements or performance metrics used to calculate their own incentive pay.

> ***PM&P Observation:*** While it was only a matter of time until the pay restrictions cascaded beyond the SEOs, below a certain level of responsibility, particularly in smaller organizations, it is questionable whether lower-level positions (and their related incentive arrangements) have a significant impact on financial or corporate results.

- **Harsher Bans on Severance to Senior Executives:** Severance for terminated SEOs is limited to one year's compensation (compared to three years under the CPP).

> ***PM&P Observation:*** The reduction in severance payments most likely will have a bigger impact on an institution's ability to attract qualified outsiders to a difficult situation versus the impact on already employed executives.

- **Approval and Disclosure of Luxury Expenditures:** Boards of directors must adopt a company-wide policy on any expenses related to: aircraft use; office and facility renovations; entertainment and holiday parties; and conferences and events. The policy must be posted on the company's website.

  PM&P Observation: This limit was clearly a reaction to some of the egregious stories in the media regarding excessive aircraft use and expensive office renovations. While comparisons have been made to the U.S. President's relatively modest compensation, that position's unique perquisites – including the White House residence, Secret Service protection and travel on Air Force One – should be factored into the equation.

The Exceptional Financial Recovery Assistance Program

Institutions that need financial aid beyond what is allowed under the GACAP may receive assistance under the EFRAP through individually negotiated agreements with Treasury. Examples of arrangements that would be covered by this program include the assistance programs provided to AIG, Bank of America and Citigroup.

Companies receiving assistance under the EFRAP will be bound by the following executive compensation restrictions:

- **$500,000 Limit on Annual Compensation (other than Restricted Stock):** Similar to the GACAP cap, but without exceptions for disclosure/say on pay.

- **Restricted Stock Cannot Vest Until Government is Repaid:** Similar to the GACAP, but also without exceptions for disclosure/say on pay.

  PM&P Observation: This structure would most likely require large grants of time-vested restricted stock to replace lost base salary and annual incentives. While restricted stock does align with long-term value, time-based vesting is in direct conflict with the "pay - for-performance" movement advocated by shareholders, the SEC and even Treasury in its 162(m) performance-based exception regulations. The large grants may also have a substantial dilutive impact, which in turn may hurt future shareholder value.

- **Executive Compensation Structure and Strategy Must be Fully Disclosed and Subject to a Say on Pay Shareholder Resolution:** Senior executives' compensation structure and the Board's rationale for how pay is tied to sound risk management, must be submitted to a non-binding shareholder resolution.

PM&P Observation: This is an explicit, rather than stealth, requirement to implement "say on pay." Such legislation has been widely discussed in Congress but not yet enacted.

- **Clawback Provisions for Top 25:** Similar to the clawback provisions for companies receiving assistance under the GACAP.

- **Harsher Bans on Severance to Senior Executives:** The top 10 executives may not receive severance payments, and the next 25 highest executives may not receive severance in excess of one year's compensation.

- **Company Policy Relating to Approval of Luxury Expenditures and Disclosure:** Similar to the GACAP requirements.

Universal Requirements

The Treasury communication includes requirements that will apply universally to all companies participating in any government program, both retroactively and prospectively. Specifically, the CEO must certify that the company has strictly complied with statutory, Treasury, and contractual executive compensation restrictions. The CEO must also re-certify compliance with these restrictions on an annual basis. In addition, the Compensation Committees of all companies receiving government assistance must provide an explanation of why their senior executive compensation arrangements do not encourage excessive and unnecessary risk-taking.

Prospects for Restrictions for Unassisted Public Companies

Treasury's communication also suggests that regulation is on the horizon outside the universe of government-assisted public companies that could:

- **Require all Compensation Committees to Review and Disclose Strategies for Aligning Compensation with Sound Risk Management**

- **Require that Incentive Compensation of Top Executives Encourage a Long-Term Perspective:** For example, Treasury suggests that top executives at financial institutions be required to hold stock awards for several years before they can be cashed-out.

- **Approve Say on Pay Shareholder Resolutions on Executive Compensation**

Conclusion

The general consensus is that it is reasonable for the Treasury to impose limitations on executive compensation at companies receiving substantial infusions of capital from taxpayers. The issue is to what degree and how such limitations will be implemented.

The new rules appear to strong-arm healthy institutions into implementing say on pay. We believe this is a significant step toward an overall say on pay outcome for all public companies, which is probably inevitable given the negative view of executive compensation in the United States.

For institutions requiring exceptional assistance, these rules may not adequately address two elements that are critical to a financial recovery and the repayment of taxpayer capital with an adequate return:

- Troubled companies need an executive team with the skills and drive to rebuild. However, Treasury's executive pay restrictions may seriously compromise the ability to attract and retain such a team amidst the current feeding frenzy to fix blame for the financial meltdown. For example, the latest prescription for a one-size-fits-all approach to executive compensation does not recognize the very different management needs of a wide range of financial organizations, from a community bank with $1-$2 billion in assets to a major institution with $1-$2 trillion in assets. A better approach may be to recognize the very diverse needs of different size organizations.

- The intense focus on risk management may have the unintended consequence of promoting overly risk-averse business decisions, such as denying reasonable credit lines to small businesses and families or creating jobs. "Just say no" is the ultimate in risk reduction, but at the same time excessive caution creates a broader economic risk of prolonging the recession and the return of taxpayer investment.

We are hopeful that regulators and Congress will take heed of these issues and adopt a reasoned and reasonable approach to protecting the interests of taxpayers, promoting good governance and putting the economy on the road to a quick recovery.

Comparison of Executive Compensation Restrictions of Five Major Assistance Programs and Possible Reform for General Application

Since the Emergency Economic Stabilization Act of 2008 was passed in early October, there have been multiple sets of executive compensation restrictions based on numerous programs and one-off situations offering government assistance under the Act. The executive compensation restrictions of the major programs to date are summarized below.

	Capital Purchase Program	Systemically Significant Failing Institutions Program	Auto Industry Financing Program	Generally Available Capital Access Program	Exceptional Financial Recovery Assistance Program	Reform Suggested for Companies Not Seeking Assistance
Review of Incentives Tied to Risk	SEOs	SEOs	SEOs	SEOs and all executives	SEOs	Compensation Committees must review and disclose how all compensation programs relate to risk and long-term value
Clawbacks	SEOs	SEOs	SEOs	Top 25 executives	Top 25 executives	
Severance	Limited to 3x for SEOs	Prohibited to SEOs	Prohibited to SEOs	Limited to 1x for SEOs	Prohibited for top 10 executives; limited to 1x for next 25 executives	
Deductibility Limitation under 162(m)(5) to $500,000	SEOs	SEOs	SEOs	SEOs	SEOs	
Cap on Annual Cash	None	None	None	$500,000 for SEOs unless it is disclosed with say on pay resolution (if requested)	$500,000 for SEOs	
Limit on Restricted Stock	None	None	None	No payout to SEOs until debt paid unless it is disclosed with say on pay resolution (if requested)	No payout to SEOs until debt paid	Focus on long-term perspective with share holding requirements
Limit on Annual Bonus	None	None	Prohibited for top 25	See Cap on Annual Cash	See Cap on Annual Cash	
Say on Pay	None	None	None	Non-binding vote as requested to qualify for exception to Annual Cash Cap/Restricted Stock rule	Non-binding vote required on structure and rationale of compensation policies	Mandatory non-binding vote on pay
Perquisites	None	None	Must divest of aircraft interest	Company policy and disclosure	Company policy and disclosure	
Certifications/ Compliance	**Required**	**Required**	**Required**	**Required**	**Required**	

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