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Troubled Assets Relief Program

Regulations & Implications for Executive Compensation

By Brian Flume and Kelly Clark
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Since its enactment, the Emergency Economic Stabilization Act of 2008 (EESA) has required that financial institutions participating in the Troubled Assets Relief Program (TARP) accept certain conditions for executive compensation and corporate governance for the period during which Treasury holds an equity stake.

On February 4, 2009, the Obama Administration and the Treasury Department issued new restrictions on executive compensation for financial services firms should they participate in the TARP in the future. The new restrictions are more rigid than the previous conditions imposed on financial institutions, and firms who have previously received TARP funding are not subject to the new regulation.

For firms who have previously received funding, there will be immense public pressure to ensure "reasonable" compensation amounts are paid to financial services executives as long as Treasury is an equity holder in the institution. There are many politicians, including our new President, who have weighed in on this issue. Adjectives, such as "unconscionable", "criminal", "pig-headed" and "misguided", have set the tone. Even if we discount the hyperbolic tendencies of our public servants—there is no denying that shareholders, directors and regulators are united in their desire to control what they believe to be excessive levels of pay.

The ultimate impact of compensation regulation for both firms that have already taken and firms that will take TARP funding has yet to be realized, because the executive compensation conditions are not finalized and are still subject to change. Still, there are some implications on executive compensation for the regulations that are already in place.

- A stronger alignment of compensation policies with risk-adjusted performance
- Greater board accountability and transparency
- Higher scrutiny of future executive employment contracts
- More frequent, non-binding shareholder say-on-pay

The attempts to control pay will undoubtedly come in the form of further restrictions, limits and/or formulas. If we are to learn anything from previous attempts to govern excessive pay like 280(g) and 162(m), we must recognize that one size does not fit all and that every well-intentioned simplistic rule results in many unintended and unfavorable consequences.

We can only hope that politicians will be guided by thoughtful proposals that acknowledge there should be a point above which compensation should cause directors to pause. This limit should vary based on roles and the firm size. The amounts above that limit should be delivered in the form of equity that cannot be sold until the government is repaid.

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To get in front of this wave of regulation, companies should examine the full range of their pay equation. For example, they should consider:

- Are salaries sufficient compensation if incentives are only to reward outstanding results? Maybe salaries should be increased to realistic levels since 162(m) limits no longer apply to any practicable extent.

- Is there a better form of incentives than "bonuses"? Not only is the term, which implies something extra (and by extrapolation something undeserved,) incendiary and misunderstood, it has historically included an amount that was an expected part of annual compensation or deferred salary. Maybe this amount should be reallocated to salary. The portion that remains should truly be an incentive that is paid for achieving outstanding results.

- Are there better ways to convince the public that equity is an incentive too? Options, by their very form, provide incentive and reward for increasing stock prices. But at today's values, many question whether executives should give something back before they share in the upside—premium priced options would answer that concern.

- What is the most appropriate type of equity compensation? Restricted stock in lieu of cash aligns executives with shareholders, but it has been criticized as a giveaway that only requires sticking around to get something. Premium vesting options, mandatory stock purchases and/or forced holdings would address those concerns.

The point is that traditional executive compensation tools (and as importantly—how they are communicated) will not survive the tide of opposition.

The new restrictions for future TARP takers, as well as those for firms who have already accepted funding, are as follows:

"EXCEPTIONAL ASSISTANCE" PROGRAM RESTRICTIONS

There are two key distinctions that need to be made prior to discussing the specifics of Treasury's new restrictions. First, the new restrictions do not apply to firms that have already received TARP funds; the policy is not retroactive. Some firms accepted TARP funds because Treasury urged them too, and others did so to ensure that other firms who accepted the funds would not have a competitive advantage. Some of these firms may not have accepted the funds had they been aware of the new restrictions and, therefore, it would not be prudent to apply restrictions retroactively.

Second, the new restrictions will only apply to firms requiring "exceptional assistance". Exceptional assistance is likened to the assistance provided to firms under the Systemically Significant Failing Institution (SSFI) Program (developed by Treasury in order to provide direct assistance to systemically significant failing firms whose failure could destabilize and disrupt financial markets) and the Targeted Investment Program (TIP) (developed in order to prevent financial instability due to the loss of confidence in a systemically significant financial institution).

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Three firms have already received funding that would be categorized as exceptional assistance, however, the new restrictions will only apply to these firms if they request further assistance. Currently for these firms, compensation restrictions were decided on a case-by-case basis and are not as strict as the new regulations.

The overall goal of the new restrictions is to ensure that top executive compensation in financial services firms is aligned not only with the interests of shareholders and the financial institutions, but also with the taxpayers. While the key distinction between the equity provided by shareholders and the equity provided by taxpayers is that the shareholders voluntarily invested in these firms, ultimately, their interests in these firms recovering and generating wealth are aligned. Treasury also wants to ensure that the recovery of these firms is not a result of "excessive and unnecessary risk taking" and therefore implemented these executive compensation restrictions to discourage that type of behavior:

- Firms must limit total compensation, other than restricted stock, for senior executives to $500,000.
    - The senior executives may receive restricted stock or similar long-term incentive amounts above the $500,000.
    - The restricted stock awards will vest when Treasury has been repaid including the contractual dividend payments or after the firm has "satisfied repayment obligations, protected taxpayer interests or met lending and stability standards."
    - There are no specific caps mentioned in the new guidelines on the levels of restricted stock awarded to senior executives.
- Firms must disclose in a non-binding shareholder resolution their compensation structure and philosophy and explain how it does not encourage excessive risk taking.
- Firms can claw back any incentives made to the top twenty five (whereas before it was only the top five) senior executives if they knowingly provide inaccurate financial information with the intention of increasing their performance-based pay.
- Firms may not make golden parachute payments to the top 25 senior executives, or pay severance greater than one year's compensation upon employment termination to the next twenty five executives.
- The chief executive officer must certify expenditures that could be viewed or classified as "excessive or luxury items."
    - The board of directors needs to adopt a company-wide policy that would cover such "excessive or luxury items" as extravagant events including holiday parties and conferences, aircraft purchases and usage, and other expenditures.
    - This is a result of recent public outcry over the disclosure of certain firms spending money on items that they were accustomed to using prior to Treasury's investment.

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GENERALLY AVAILABLE CAPITAL ACCESS PROGRAM PROPOSED GUIDANCE

Along with the new restrictions for exceptional assistance programs, Treasury also issued proposed guidance for firms that will participate in generally available capital access programs. The Capital Purchase Program (CPP) is a generally available capital access program and has been the most widely used form of government funding with over 350 firms participating.

The proposed guidelines are subject to public comment and do not apply retroactively, therefore firms would only be subject to these restrictions if they participate in any TARP program going forward. The proposed guidelines are very similar to the requirements for firms receiving "exceptional assistance" with a few key distinctions:

- The guidelines include a limit of $500,000 in total annual compensation that can be waived by enacting a non-binding "say-on-pay" resolution to shareholders and by disclosing the compensation structure for both senior executives and other employees.
  - The key difference between the compensation structure disclosure in the proposed guideline and the current policy is that the coverage extends to other senior executives in addition to the top five executives.
  - The firm would be required to disclose the compensation arrangements that ensure that they do not encourage "excessive and unnecessary risk taking."
- The bonus clawback provisions for top executives engaged in deceptive practices would be extended from covering the top five executives to include the next twenty senior executives.
- While golden parachute prohibitions in the proposed guidelines still only apply to the top five senior executives, the maximum amount awarded upon severance would be decreased to one year's compensation (the previous maximum was three years' total compensation).
- The proposed guidelines would require firms to enact a strict policy regarding the approval of luxury or excessive expenditures and would have the same requirements as those described for firms receiving exceptional assistance.

CAPITAL PURCHASE PROGRAM RESTRICTIONS FOR ALREADY PARTICIPATING FIRMS

The firms to which Treasury has already provided direct equity capital are subject to the following executive compensation provisions:

- Firms must ensure that all incentive compensation for SEOs does not encourage unnecessary and excessive risk taking that threatens the overall value of the firm. In order to comply with this provision, the compensation committee is required to:
  - Meet with the Senior Risk Officer (SRO) within 90 days after the CPP transaction to discuss any incentive compensation practices that may encourage risk taking
  - Meet with SRO annually after the initial meeting
  - Certify annually in the Compensation Committee Report that it complied with this condition

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- Participating financial institutions must claw back any bonus or other incentive compensation earned during Treasury holding period to a SEO based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate. This provision differs from the requirements previously listed in Sarbanes-Oxley in that it:
  - Applies to all SEOs, not just the CEO or the CFO
  - Applies to both public and private firms participating in the CPP
  - Is not exclusively triggered by a financial restatement
  - Does not limit the recovery period to the previous 12 months
  - Covers both material inaccuracies relating to financial reporting and inaccuracies related to other performance metrics for awarding bonuses and other incentive compensation
- Firms are also prohibited from making any golden parachute payment to a SEO based on the Internal Revenue Code § 162(m).
  - A golden parachute payment is defined for the EESA as any severance payment to an SEO that is equal to or greater than three times the SEO's five year average annual earnings.
- Firms must agree not to deduct for tax purposes executive compensation in excess of $500,000 for each SEO. Firms must also eliminate performance-based compensation exceptions and continue "disqualified individual status" thereby removing the option for providing post-retirement lump sums.

The Treasury recently issued specific regulations regarding the management of reporting and recordkeeping in order to ensure compliance with the executive compensation standards mentioned above. The firm's Principal Executive Officer needs to certify that:

- The firm and the compensation committee are in compliance with the aforementioned executive compensation regulations (to be completed within 135 days after the end of each fiscal year during any part of which the firm has participated in the CPP).
- The firm has limited the deduction for remuneration for federal income tax purposes to $500,000 (to be completed within 135 days after each fiscal year-end after the first fiscal year during any part of which the institution has participated in the CPP).
- The compensation committee has reviewed SEO incentive compensation agreements with senior risk officers to ensure that the agreements do not encourage unnecessary and excessive risks (to be completed within 120 days of the closing date of the Securities Purchase Agreement).

These certifications must be provided to the TARP Chief Compliance Officer, and the financial institution is required to keep all certification records for a period of no less than six years after the date of certification, the first two years in an accessible place.

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CONCLUSION

The overall goal of an effective executive compensation structure is to attract, retain and motivate executives to increase shareholder value. Now that Treasury, as a conduit for the tax-payers, is a major shareholder in these organizations, the executive compensation structure must accommodate the restrictions that apply to receiving public funds.

Other than the elimination of cash bonus compensation and stricter vesting requirements, the restrictions proposed by Treasury are not significantly different than many of the programs already in place at many financial institutions. Many firms' executives not only were awarded high levels of restricted stock and options before the financial crisis, but also had specific ownership provisions that prohibited them from liquidating most of their equity holdings until retirement.

Ultimately, many of the restrictions discussed above are open for interpretation and are subject to change. What is important to take into consideration when designing an executive compensation structure is to ensure that it is transparent, it does not encourage excessive risk taking, and the long-term interests of the executives are aligned with the shareholders—including the tax payers. ■

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