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Federal Government Fires More Salvos At Executive Compensation

The federal government's extraordinary multi-pronged attack against executive compensation practices took another step forward, this time with the Federal Reserve Board of Governors ("FRB") taking aim. On October 22, 2009, the FRB proposed new guidance that will dramatically affect incentive compensation arrangements for the banking industry. The proposed guidance is consistent with and largely patterned after the multi-national Financial Stability Board's September 25, 2009 report titled "FSB Principles for Sound Compensation Practices." Not to be left out of the headlines, on the same day, the Special Master for the government's Troubled Asset Relief Program ("TARP") Executive Compensation also announced significant reductions in compensation for the top executives and employees at companies receiving exceptional TARP assistance along with various other mandated reforms to compensation practices.

As we have previously commented (see for example our June 18, 2009 blog), the federal government believes poor executive compensation practices significantly contributed to the financial meltdown of the last couple of years and that such practices must be reformed. Indeed, President Obama commended the Special Master's actions and stated that the Special Master has taken an "important step forward in curbing the influence of executive compensation on Wall Street while still allowing these companies to succeed and prosper." President Obama also endorsed the House-approved Say-On-Pay legislation (see our August 7, 2009 and July 22, 2009 blogs) when he urged the Senate to "pass legislation that will give company shareholders a voice on the pay packages awarded to executives."

FRB Proposed Guidance

In justifying its intervention into corporate incentive compensation decision-making, the FRB made the remarkable assertion that aligning the interests of shareholders and employees is not by itself always sufficient to protect the safety and soundness of a banking organization. Echoing a recurring theme in the government's endeavors to reform compensation practices, the FRB's proposed guidance is intended to ensure that incentive compensation policies at banking organizations do not encourage excessive risk-taking by employees. The guidance will apply to all banking organizations supervised by the FRB and will cover not only senior executives but also employees who have the ability, either individually or as part of a group, to expose a banking organization to material amounts of risk.

Comments on the guidance can be submitted during the thirty days after its publication in the Federal

Register. However, the FRB expects banking organizations to immediately review their incentive compensation arrangements to ensure that they do not encourage excessive risk-taking and to implement corrective programs where needed. The FRB may even take "enforcement action against a banking organization if its incentive compensation arrangements or related risk management, control, or governance processes pose a risk to the safety and soundness of the organization and the organization is not taking prompt and effective measures to correct the deficiencies." Additionally, the FRB is commencing two supervisory initiatives of incentive compensation practices at banking organizations to (i) ensure the implementation of safe and sound incentive compensation arrangements, (ii) identify emerging best practices and (iii) advance the state of practice in the banking industry.

There are three overarching core principles that are the foundation of the FRB's proposed guidance. These principles provide that incentive compensation arrangements at a banking organization should:

- Provide employees incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk;

- Be compatible with effective controls and risk management; and

- Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

The proposed guidance provides a number of specific recommendations for the proper implementation and administration of incentive compensation arrangements including:

- *Balanced Risk-Taking Incentives* - An incentive compensation arrangement should be balanced and take into account the risks taken when determining the amounts of any payout to an employee. Under this philosophy, if two employees achieved the same performance result, the employee whose activities produced a materially higher level of risk would receive lesser incentive compensation. Additionally, a banking organization should consider utilizing forward-looking scenario analysis to help assess whether the features included in incentive compensation arrangements are likely to achieve balance over time.

- *Longer Performance Periods* - The time period covered by performance measures used to determine an employee's award should be extended. And, the banking organization should reduce the rate at which awards increase as an employee achieves higher levels of the relevant performance measures.

- Deferral and Clawback - The actual payout of an award to an employee should be delayed significantly beyond the end of the performance period and such amounts paid should be decreased for actual losses or other aspects of performance that become clear only during the deferral period.

- *Golden Parachutes and Deferred Compensation* - Banking organizations should carefully review any existing or proposed golden parachute arrangements, along with the vesting conditions for deferred compensation, and their potential impact on the organization's safety and soundness.

- *Effective Controls and Risk Management* - A banking organization’s risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

- *Role of Risk Management Personnel* - Appropriate personnel, including risk-management personnel, should have input into the organization’s processes for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking. Moreover, compensation for those employees in risk management and control functions should be sufficient to attract and retain qualified personnel and the use of such personnel should avoid conflicts of interest.

- *Strong Corporate Governance* - Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices. The organizations should generally have a committee of independent directors that has primary responsibility for overseeing the organization’s incentive compensation programs.

- *Use of Independent Counsel* - The board of directors should have the authority to select, compensate, and use outside counsel, consultants, or other experts with expertise in incentive compensation and risk management. Due attention should be provided to potential conflicts of interest associated with the use of such parties.

- *Transparent Disclosure* – There should be clear disclosure of incentive compensation arrangements to shareholders. Moreover, the FRB will work with the Securities and Exchange Commission to "improve the disclosures provided by public banking organizations in ways that promote the safety and soundness of these organizations." Banking organizations should also effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.

Mandated Reduction in Compensation and Reform of Compensation Practices for TARP Companies

As proclaimed in the Treasury Department’s announcement, the Special Master’s October 22, 2009 rulings represent a “fundamental transformation from the pay practices of the past.” The Special Master was acting in accordance with its mandate under the Emergency Economic Stability Act of 2008, as amended in 2009, to review all forms of compensation for the five most senior executive officers and the next twenty most highly compensated employees at those companies that receive exceptional TARP assistance. Each of these companies received a letter from the Special Master containing specific determinations regarding compensation for 2009.

Consistent with Treasury's February 4, 2009 guidelines restricting executive pay, the Special Master's actions generally:

- *Significantly Reduce Salaries and Cash Compensation*
- *Reject Short-Term Bonuses in Favor of Stock Grants that must be held Long-Term*
- *Require Objective Performance Goals that are Pre-Established with the Special Master*
- *Require Executives to Render Service for At Least Three Years After Incentive Award is Made*
- *Require Incentive Awards to be in Form of Restricted Stock that Cannot be Paid Unless Company Repays its TARP Obligations*
- *Significantly Curtail Compensation that is not Performance Based including Golden Parachutes, Perquisites, and Supplemental Retirement Plan*s

Conclusion

Banking institutions and companies receiving TARP assistance will obviously have to examine (and modify as needed) their compensation arrangements and policies to ensure regulatory compliance. But beyond this, the government's espoused tenets of pay for performance, long-term stock ownership, risk minimization, and checks and balances on compensation through fulsome disclosure and independent decision-making aided by independent counsel/advisors will continue to be touted as best practices for all companies. Accordingly, as we have previously commented (see our prior blogs on August 7, 2009, July 22, 2009, July 17, 2009 and June 18, 2009), companies should carefully review their compensation processes and arrangements, risk management procedures, relationships with their compensation advisors and counsel, and compensation-related disclosures.

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