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New TARP Executive Compensation Guidance and a Call for Further Reform in Executive Compensation Practices

June 10,2009 marked an extraordinary day of announcements affecting executive compensation for both recipients of financial assistance from the Troubled Asset Relief Program ("TARP") and other publicly held companies, including:

- The U.S. Department of the Treasury ("Treasury") issued a statement outlining the Administration's expectations and planned legislative proposals for executive compensation reform for publicly held companies.

- The Securities and Exchange Commission ("SEC") announced it will soon be proposing new expanded compensation disclosure rules that could take effect in time for the 2010 proxy season.

- The Treasury issued regulations providing its much anticipated guidance on standards for executive compensation and corporate governance for TARP recipients.

- The Treasury established an Office of the Special Master for TARP Executive Compensation (the "Special Master").

The coordinated issuance of these executive compensation rules and guidelines by various agencies of the federal government demonstrates that executive compensation reform is an important part of the Obama Administration's agenda. The continuing evolution of corporate governance standards and best practices for compensation programs and the associated disclosure of such arrangements is likely to continue to be a fact of life for public companies. Moreover, the imposing array of executive compensation standards and requirements established for TARP recipients illustrates the government's resolve to preempt any perception of excessive compensation at companies receiving TARP assistance and also to promote better pay for performance practices at other companies as well.

Treasury's Guidelines for Executive Compensation Reform

Due to the Treasury's view that executive compensation practices were a contributing factor to the on-going financial crisis, the Treasury announced a broad-based set of principles for publicly held companies. These principles are:

- Compensation plans should be tied to performance in order to link the incentives of executives and other employees with long-term value creation. To align with such long-term value creation, performance-based pay should be conditioned on a wide range of internal and external metrics, not just stock price.

- Compensation, including compensation for more than just the top executives, should be structured to account for the time horizon of risks. Similar to the first principle, the objective is to align the compensation to the long-term health of the enterprise.

- Compensation practices should also be aligned with sound risk management. Compensation committees should conduct and publish risk assessments of pay packages to ensure that they do not encourage imprudent risk-taking. Providing greater authority to a company's risk managers may become a by-product of this principle.

- Golden parachutes and supplemental retirement packages should be reexamined so as to ensure proper alignment of the interests of executives and shareholders. Again, the objective is to ensure that poor performance is not rewarded.

- Transparency and accountability in the process of setting compensation should be promoted.

Treasury's Planned Legislative Proposals

To help promote the fifth principle of transparency and accountability, the Administration will seek legislation to give the SEC the authority to implement two new requirements: (i) shareholder "Say on Pay" and (ii) enhancement of the independence of compensation committees. The Treasury also released two "fact sheets" providing further details on these two initiatives.

The contemplated "Say on Pay" legislation would give the SEC the authority to require non-binding annual "say on pay" votes for public companies. Shareholders would then have the right to, among other things, approve (or disapprove): golden parachute compensation, annual compensation for the top five named executive officers, and executive pay packages as disclosed by the public company in its annual proxy statement.

The contemplated enhancement of the independence of compensation committees would direct the SEC to promulgate rules requiring companies listed on national securities exchanges to meet more exacting standards for independence. In particular, the compensation committee members would need to meet the stricter independence standards required of audit committee members as imposed by the Sarbanes-Oxley Act of 2002. In addition, the compensation committee would have authority to retain counsel and consultants. Further, the SEC will be directed to establish standards regarding the independence of the compensation counsel and consultants used by the compensation committee.

Moreover, the President's Working Group on Financial Markets will provide an annual review of compensation practices to monitor whether such practices are creating excessive risks. The Treasury is also encouraging experts in the field to conduct reviews to identify best practices, emerging positive and negative trends and call attention to unseen risks.

SEC's Planned Proposal of Expanded Compensation Disclosure Rules

The SEC announced that it will soon be proposing new expanded compensation disclosure rules which will compel companies to analyze how compensation impacts risk taking and the implications for long term corporate health. Specifically, the SEC will be considering several proposals including requiring public companies to provide fuller disclosure on:

- How a company, and its board, manages risks in its executive compensation program.
- A company's overall compensation approach and how its incentive structures take into account the potential long term effects on the company.
- Compensation consultant independence and conflicts of interest; and
- Director nominees, including their experience, qualifications to serve on the board or committees, and why a board has chosen its particular leadership structure.

These planned proposals dovetail with the SEC's June 10, 2009 proposed rule (17 CFR Parts 200, 232, 240, 249 and 274) that is intended to remove impediments so shareholders may more effectively exercise their rights to nominate and elect directors.

Treasury's Executive Compensation Guidance to TARP Recipients

The Treasury also issued a revised Interim Final Rule 31 CFR Part 30 ("IFR") providing further guidance on the corporate governance and executive compensation provisions of the Emergency Economic Stabilization Act of 2008 ("EESA"), as amended by the American Recovery and Reinvestment Act of 2009 ("ARRA"). Details of the original executive compensation EESA provisions can be found in our October 21, 2008 Blog

Article. The IFR supersedes its two predecessor IFRs that were previously released in January 2009 and October 2008, respectively. The updated IFR implements ARRA's executive compensation provisions which generally replaced the original provisions that were enacted under EESA in October 2008. The new guidance not only clarifies certain details related to ARRA's executive compensation restrictions and standards, but it also provides additional new standards pursuant to its authority granted by ARRA. Note, the IFR applies not only to public companies but also to privately held TARP recipients.

The IFR's new standards include:

- A prohibition on tax gross-ups to senior executive officers and the next twenty most highly compensated employees;

- A requirement of disclosure and a narrative description of, and justification for, any perquisites, with total value exceeding $25,000, provided to any employee subject to ARRA's bonus limitations; and

- Mandatory disclosure of any compensation consultant engaged by the company or its compensation committee, including a narrative description of the services provided and the use of any "benchmarking" procedures in the consultant's analysis.

Below is a listing of other executive compensation items addressed in the IFR, in addition to the three new standards outlined directly above, which generally apply to all TARP recipients:

- Limits on executive compensation that exclude incentives for senior executive officers ("SEO") to take unnecessary and excessive risks that threaten the value of the TARP recipient;

- Requirement for the recovery of any bonus, retention award, or incentive compensation paid to a SEO or the next twenty most highly compensation employees based on materially inaccurate statements of earnings, revenues, gains or other criteria;

- Prohibition on making any golden parachute payment to a SEO or any of the next five most highly compensated employees;

- Prohibition on the payment or accrual of bonus, retention award, or incentive compensation to SEOs or certain highly compensated employees, subject to certain exceptions for payments made in the form of long-term restricted stock;

- Prohibition on employee compensation plans that would encourage manipulation of earnings reported by the TARP recipient to enhance an employee's compensation;

- Establishment of a compensation committee of independent directors to meet semi-annually to review employee compensation plans and the risks posed by these plans to the TARP recipient;

- Adoption of a company-wide excessive or luxury expenditures policy;

- Compliance with federal securities rules and regulations regarding the submission of a non-binding resolution on SEO compensation to shareholders; and

- Appointment of a Special Master to approve compensation plans of certain TARP recipients and to provide guidance to other TARP recipients.

Moreover, the IFR also establishes compliance reporting and recordkeeping requirements covering the various executive compensation and corporate governance standards. The principal executive officer and principal financial officer of a TARP recipient must provide certain certifications in their annual report on Form 10-K and to the Treasury (for public companies) and to the primary regulatory agency and Treasury for other entities. Providing false information or certifications may subject the entity or individual to criminal penalties.

While the IFR is effective as of June 15, 2009, *i.e.*, the date the IFR was published in the Federal Register, public comments can be submitted to the Treasury on the topics addressed in the IFR through August 14, 2009.

Treasury's Special Master for TARP Executive Compensation

The Treasury also announced the appointment of a Special Master for TARP Executive Compensation. In this role, the Special Master will, among other things, have broad authority over the compensation for all executive officers and the 100 most highly paid employees of TARP participants who are receiving "exceptional financial assistance", including the power to reject compensation pay plans deemed excessive. Exceptional financial assistance is deemed to currently cover all entities participating in the Programs for Systemically Significant Failing Institutions, the Targeted Investment Program, or the Automotive Industry Financing Program. The Special Master also has the authority to interpret ARRA's executive compensation requirements and shall review bonus/retention payments made before ARRA's enactment to certain employees of all TARP recipients to ensure that such payments are not inconsistent with ARRA or contrary to public interest. The Special Master has the responsibility and ability to seek reimbursement of those payments which the Special Master has determined do not satisfy these requirements.

The Special Master will apply a set of principles to determine whether the TARP recipients have designed executive compensation to maximize shareholder value and protect taxpayer interests, including whether compensation:

- Avoids fostering unnecessary/excessive risk taking;
- Allows a company to be competitive, recruit/retain valued employees and is able to repay its TARP obligations;
- Is appropriately allocated between types of pay (e.g., salary, long-term incentive pay, retirement), and form of payment, with an emphasis on long-term pay for senior level positions;
- Is performance-based, determined through tailored metrics that provide goals whose attainment is not guaranteed, and which accounts for a greater portion of total compensation for positions with higher levels of responsibility;
- Is comparable to peers; and
- Properly values the employee's overall current/future contributions to the employer.

In summary, the IFR imposes executive compensation requirements that are quite extensive and compliance with all of these rules will likely involve a material change in a TARP recipient's compensatory processes and practices. Moreover, the Administration clearly would like its executive compensation principles to be adopted as best practices for those companies which are not receiving TARP assistance. As “Say on Pay” legislation and enlarged proxy statement disclosures are likely to become a reality, public companies may now want to examine and make changes as appropriate to their existing compensation processes, structures, programs and disclosures in order to be prepared for the impending expansion of executive compensation rules and disclosures.

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