



Treasury Issues Interim Final Rule on Executive Compensation Restrictions for TARP Recipients

On June 10, 2009, the Treasury Department issued an interim final rule on the executive compensation restrictions for companies receiving federal assistance under the Troubled Asset Relief Program (TARP). Among other things, the regulations establish a Special Master, prohibit tax gross-ups, require adoption of an excessive or luxury expenditures policy, expand clawback provisions, place additional prohibitions on bonuses and incentive compensation for senior executive officers and certain highly compensated employees, and implement more rigorous requirements for companies receiving “exceptional financial assistance.”

Background

The Emergency Economic Stabilization Act (EESA) included restrictions on the executive pay practices of institutions receiving governmental bailout funds under the Troubled Asset Relief Program (TARP). (See our October 20, 2008 [For Your Information](#).) On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act which contained amendments to the executive pay restrictions under TARP. (See our March 2, 2009 [For Your Information](#).)

There has until now been very little guidance on how to apply EESA's executive compensation provisions. For example, TARP companies were uncertain about how to apply specific limitations associated with restricted stock grants and how to define the applicable highly compensated employee group affected by these limitations.

BUCK COMMENT. *On June 17, 2009, President Obama issued a proposal calling for far-reaching changes that would affect firms within the financial sector regardless of TARP status. Many of the proposed changes involving compensation structures call for increased federal oversight and disclosure. Coupled with Treasury Secretary Geithner's recently disclosed general principles on executive compensation reform (see our June 16, 2009 [For Your Information](#)) and other legislative proposals, it would appear that significant changes involving compensation of companies more broadly than TARP recipients are forthcoming.*

Interim Final Rule

Treasury has now issued [interim regulations](#) on the executive compensation and corporate governance provisions imposed under Section 111 of EESA. The regulations apply to any entity that has received or will

receive financial assistance under TARP including, generally, any entity of which the TARP recipient owns at least 50%, or which owns at least 50% of the TARP recipient.

The requirements generally apply for the period during which any obligation arising from financial assistance under TARP remains outstanding except any period during which the federal government only holds warrants to purchase common stock of the TARP recipient.

Determination of Senior Executive Officers and Most Highly Compensated Employees. Certain requirements in the regulations apply to senior executive officers (SEOs) and a certain number of the “most highly compensated employees.” In general, the determination of the SEOs is drawn from the executive compensation proxy disclosure rules, which generally apply to the principal executive officer (PEO), the principal financial officer (PFO), and the three most highly compensated executive officers other than the PEO and the PFO. Annual compensation is defined as the dollar value of the total compensation as determined for purposes of the Summary Compensation Table (SCT) disclosure requirements under SEC rules. For the most highly compensated employees that are not SEOs the determination is made using their annual compensation for the last completed fiscal year, as if the SCT disclosure requirements were applicable to such individuals.

***BUCK COMMENT.** TARP companies may have to expand their tracking of compensation (as determined for SCT reporting) for a wider group of employees. Further, current SEC rules only require disclosure of the annual accounting charge associated with equity awards instead of the full grant date fair value of such awards. Many believe that the SEC will eventually change its disclosure rules for equity awards, which would have an impact on determining most highly compensated employee status.*

Generally, analogous rules apply to TARP recipients that do not have securities registered with the SEC.

Establishment of Special Master. The regulations establish the Office of the Special Master for TARP Executive Compensation who will be responsible for addressing executive compensation provisions under TARP. Kenneth Feinberg has been assigned to this role for the primary purpose of monitoring compensation practices of firms receiving “exceptional financial assistance” (see below). Only TARP recipients that receive assistance under the Programs for Systemically Significant Failing Institutions, the Targeted Investment Program, and the Automotive Industry Financing Program currently fall into that category.

The Special Master is also expected to act as a resource for all TARP recipients to provide general guidance and help interpret rules. TARP recipients that are not receiving exceptional assistance may apply to the Special Master for an advisory opinion with respect to compensation payments and structures.

Compensation Committee Requirements. The regulations include several significant requirements relating to the compensation committee of the TARP recipient’s board of directors and its duties.

Independence Requirement. The regulations require TARP recipients to establish compensation committees composed of independent members of the board of directors to fulfill a number of duties. The committees must

be established within 90 days after the later of the closing date of an agreement between Treasury and the TARP recipient or June 15, 2009.

BUCK COMMENT. *Many public company TARP recipients already maintain compensation committees of independent directors pursuant to stock exchange listing standards. The regulations allow already-established compensation committees to be maintained.*

TARP recipients that have no publicly-traded securities and have received \$25,000,000 or less in financial assistance are permitted to either establish a compensation committee of independent directors or to delegate, as appropriate, to its board of directors the duties of the compensation committee as described below.

Assessment of Material Risks or Potential for Earnings Manipulation. At least every six months, compensation committees are required to review CEO and employee compensation plans with senior risk officers and the risks (both short-term and long-term) these plans pose. They must identify and limit the features in the plans that could lead CEOs to take unnecessary and excessive risks that could threaten the value of the TARP recipient, identify and limit risks associated with employee compensation plans, and also ensure that the plans do not encourage behavior focused on short-term results rather than long-term value creation. In addition, compensation committees are required to review at least every six months the terms of each employee compensation plan to identify and eliminate the features in the plan that could encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of an employee. Compensation committees are required to certify annually and provide a narrative description of how they limited the features in CEO and employee compensation plans to prevent material risks or earnings manipulation. TARP recipients with securities registered with the SEC must provide these certifications in the Compensation Committee Report in the company's annual proxy. TARP recipients that are smaller reporting companies or do not have registered securities must provide the disclosures and certifications to their primary regulatory agency.

BUCK COMMENT. *It is important to note that these requirements apply not only to CEO arrangements but also to broader "employee compensation plans." Thus, a broad and comprehensive set of procedures will need to be developed and implemented to ensure compliance with these requirements.*

Clawback Requirements. TARP recipients are required to ensure that any bonus, retention award, or incentive compensation paid or accrued during the TARP period to a CEO or one of the next twenty most highly compensated employees is subject to a provision for clawback by the TARP recipient if the payments or accruals were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

BUCK COMMENT. *The mandatory clawback provisions are far more expansive than those required under the Sarbanes-Oxley Act. Further, the requirement for clawbacks in the case of material inaccuracies relating to performance metrics will require careful review and assessment of the systems and procedures in place for monitoring and reporting satisfaction of specified performance criteria.*

Golden Parachute Prohibition. TARP recipients are prohibited from making a golden parachute payment to an CEO or the next five most highly compensated employees during the TARP period. A golden parachute payment includes a payment for departure from a TARP recipient for any reason, other than a payment for services performed or benefits accrued. The regulations also treat change of control payments as golden parachute payments.

Prohibition on Paying or Accruing Bonuses, Retention Awards, Incentive Compensation. TARP recipients are prohibited from paying or accruing any bonus, retention award, or incentive compensation during the TARP period to certain employees.

Definition of Bonus, Retention Awards, or Incentive Compensation. The regulations contain detailed definitions of bonus, retention award, and incentive compensation for these purposes. Generally, the limitations will not apply to bonuses, retention awards, and incentive compensation paid or accrued by TARP recipients prior to June 15, 2009. Incentive compensation includes stock options and restricted stock awards regardless of whether or not such awards are subject to performance-based vesting. However, there is no restriction on the ability to pay salary or other permissible payments in the form of stock or other property – as long as the amount of the future payment is denominated in dollars, rather than in number of shares, and is not subjected to any vesting requirements. Generally, amounts accrued under a nonqualified deferred compensation plan will not be considered in either of the three prohibited categories (subject to exceptions).

Employees Covered Depends on Level of TARP Assistance. The TARP recipient's amount of financial assistance determines the number of employees subject to this prohibition as follows –

- less than \$25,000,000 – only the most highly compensated employee
- at least \$25,000,000 but less than \$250,000,000 – at least the five most highly compensated employees
- at least \$250,000,000 but less than \$500,000,000 – the CEOs and at least the ten next most highly compensated employees
- \$500,000,000 or more – the CEOs and at least the 20 next most highly compensated employees.

Anti-manipulation Provisions. To avoid manipulation of the rules by merely delaying payments to post prohibition periods, payments or legally binding rights to payments will be traced back to service periods during which the employee was an CEO or most highly compensated employee subject to the prohibitions. A bonus, a retention award, or incentive compensation that an employee accrues while the employee is not subject to the prohibition but would ordinarily be payable during a period when the employee is subject to the prohibition may not be paid until the employee is no longer subject to the prohibition. Further, although there is no specific cap on base salary, it appears that the rules are designed to prohibit manipulation of compensation by shifting the composition of pay from any of the prohibited categories to base salary.

BUCK COMMENT. *The following examples help to illustrate these provisions.*

Example 1. Employee A is an SEO of a TARP recipient in 2010, but not in 2011. The TARP recipient maintains an annual bonus program, generally paying bonus payments in March of the following year. Employee A may not be paid a bonus payment in 2010 (for services performed in 2009 or any other year). In addition, Employee A may not be paid a bonus payment in 2011 to the extent such bonus payment is based on services performed in 2010.

Example 2. Same facts as in Example 1, but Employee A receives a salary increase for 2011. The salary increase equals the same percentage as similarly situated executive officers, with an additional percentage increase which, over the course of twelve months, equals the bonus that would have been payable to Employee A in 2011 (for services performed in 2010), except for application of the prohibition. The additional percentage increase will be treated as a bonus payment accrued in 2010 and may not be paid to Employee A.

Exceptions for Restricted Stock and Grandfathered Amounts. There are two exclusions from the prohibitions on bonuses, retention awards, or incentive compensation –

- **Restricted Stock Awards.** The prohibition on the payment or accrual of bonus, retention award, or incentive compensation does not apply to an award of long-term restricted stock subject to certain requirements. The rules define “long-term restricted stock” to include both restricted shares and restricted stock units, which can be settled in stock or cash, and which may be designed to track a specific unit or division within a TARP recipient. The value of the long-term restricted stock can be no greater than 1/3 of the employee’s total annual compensation. Annual compensation and the value of the restricted stock grant will be determined on a current fiscal year basis (no lookbacks to prior fiscal years). Further, the value of the long-term restricted stock will be based on its total fair market value on the grant date. Any equity-based compensation granted in fiscal years ending prior to June 15, 2009 will not be included in the calculation of annual compensation.

BUCK COMMENT. *The calculation of total annual compensation under this restriction is markedly different from the calculation used to determine the SEOs and most highly compensated employees each year (i.e., the SEC’s Summary Compensation Table disclosure rules). Additional guidance is required for acceptable methodologies used to value certain awards.*

The long-term restricted stock must not fully vest until the repayment of all financial assistance by the TARP recipient. In addition, the employee is required to provide services to the TARP recipient for at least two years after the date of the grant prior to vesting. Further, the award is subject to a schedule under which it may become transferable (or in the case of a restricted stock unit, payable). That is, for each 25% of total financial assistance repaid, 25% of the total long-term restricted stock granted may become transferable, until the final repayment, at which time the remaining long-term restricted stock may become transferable.

- **Grandfathered Amounts.** The rules also exclude from the prohibition any bonus, retention award, or incentive compensation payment required to be paid under a valid written employment contract executed on or before February 11, 2009 if the employee has a legally binding right (as determined under the Section 409A deferred compensation rules) under the contract to this payment.

Excessive or Luxury Expenditure Policy. The board of directors of a TARP recipient is required to adopt an excessive or luxury expenditures policy, file the policy with Treasury, and post the text of the policy on its website within 90 days after the later of the closing date of the agreement between Treasury and the TARP recipient or June 15, 2009. There are a series of rigorous requirements that must be met for the policy to be compliant.

Say-on-Pay for SEO Compensation. TARP recipients are required to permit a nonbinding shareholder resolution on SEO compensation.

Companies Receiving Exceptional Financial Assistance. TARP recipients receiving “exceptional financial assistance” are required to submit for approval the compensation payments and compensation structures of the CEOs and most highly compensated employees that are subject to the prohibitions on bonus, retention award and incentive compensation, and the compensation structures of all other executive officers and the 100 most highly compensated employees, for approval by the Office of the Special Master (see above).

However, if the total annual compensation to an employee complies with the rules applicable to an CEO (applied without any limits on the grant of long-term restricted stock), and the annual compensation other than long-term restricted stock does not exceed \$500,000, the compensation structure will automatically be deemed to meet the requirements and no prior approval will be required.

Disclosure of Perquisites and Compensation Consultants. TARP recipients are required to disclose to Treasury and their primary federal regulator annually any perquisites whose total value exceeds \$25,000 for any employee who is subject to the prohibitions on bonuses, retention awards and incentive compensation. TARP recipients are required to identify the amount and nature of the perquisites and disclose a justification for offering them. A TARP recipient must also disclose annually whether the TARP recipient, its board, or its compensation committee has engaged a compensation consultant and all types of services the compensation consultant provided to the TARP recipient, board, or compensation committee during the past three years, including any “benchmarking” or comparisons employed to identify certain percentile levels of compensation.

Prohibition of Tax Gross-Ups. TARP recipients are prohibited from providing tax gross-ups or other reimbursements for the payment of taxes to any of the CEOs and next 20 most highly compensated employees relating to severance payments, perquisites, or any other form of compensation.

Annual Compliance and Reporting Requirements. The regulations also establish compliance reporting and recordkeeping requirements. The CEO and CFO of the TARP recipient are required to provide certifications

within 90 days of the end of each fiscal year that the standards have been met. A knowing and willful false or fraudulent statement made in connection with the certification is punishable by fine, imprisonment, or both.

There are several additional certification requirements for TARP recipients receiving exceptional financial assistance. TARP recipients that have securities registered with the SEC must provide these certifications on their annual Form 10-K and to Treasury. A TARP recipient that does not have securities registered with the SEC must provide these certifications to its primary regulatory agency and to Treasury.

BUCK COMMENT. *The reporting and recordkeeping requirements are quite extensive. The certification requirements are in addition to those required by the compensation committee and more broadly require the PEO and CEO to address virtually all of the restrictions under the regulations.*

Conclusion

Buck's consultants are closely following the developments affecting companies receiving TARP assistance as well as developments that may affect executive compensation in general. While the regulations are generally effective as of June 15, 2009, Treasury is requesting comments by August 14, 2009, which it will consider in developing final regulations. Buck's consultants are available to help affected companies review executive compensation practices to comply with these requirements.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.