

# Understanding the Newly Released TARP Compensation Guidelines

## What the Rules Mean – for TARP Banks and Beyond

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## ■ Our Speakers

**Susan O'Donnell**

***Managing Director***

Susan O'Donnell, a Managing Director in the Boston office, specializes in the banking industry and has advised banking clients for over 22 years on executive, director and staff compensation issues.

**[susan.odonnell@pearlmeyer.com](mailto:susan.odonnell@pearlmeyer.com) (508) 630-1493**

**Deborah Lifshey**

***Managing Director***

Deborah Lifshey, a Managing Director in the New York office, specializes in advising clients on compensation matters from a legal perspective, including securities disclosure, taxation and corporate governance issues, as well as contract negotiation and reasonableness opinion letters.

**[deborah.lifshey@pearlmeyer.com](mailto:deborah.lifshey@pearlmeyer.com) (212) 644-2300**

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## ■ Today's Discussion

- **Government Actions To Date**
  - Deciphering the many intertwining regulations
- **The TARP Interim Final Rules (IFR)**
  - Overview
  - Affected executives and employees
  - Specific compensation restrictions
  - Compliance/process requirements
  - Broader implications/issues
- **Considerations and Actions**
  - TARP Participants
  - All Companies











## ■ Evolution and Government Actions to Date

- **10/08: TARP established under EESA**
- **10/20/08: October Guidance**
  - October 2008 IFR on CPP rules (Capital Purchase Program)
  - Treasury Notice 2008-PSSFI (Failing Institutions)
  - Notice 2008-TAPP (Auction Programs)
- **2/4/09: Treasury issues new guidance**
  - Exceptional Assistance Program & Generally Available Capital Access Program (never formally adopted)
- **2/13/09: ARRA amended EESA**
  - Many understood this to mean it superseded 2/4/09 guidance
- **6/10/09: Several significant announcements**
  - Interim Final Rules (IFR) for TARP participants
  - Treasury announces “Broad Principles” for all companies
  - Special Master/Pay Czar to oversee TARP participants receiving “exceptional assistance”
  - Commitment to legislation regarding to Say on Pay and Compensation Committee Independence (shared by Treasury, SEC and Federal Reserve Board)
- **7/1/09 (Anticipated): SEC to discuss in open forum updated disclosure rules and elimination of broker vote**

## ■ Interim Final Rules (IFR) Synopsis

- **Provides guidance on EESA, as amended by ARRA**
- **Applies to TARP Recipients**
- **Intent is consolidation of prior guidance**
- **Concepts introduced for first time include**
  - Prohibition on all tax gross-ups to CEOs + 20 (25)
  - Additional perquisite disclosure
  - Enhanced disclosure about compensation consultants
  - Broader application of certain provisions to all employees (i.e., risk assessment)
- **Some provisions likely to cascade to broader industry**

# Summary of Rules and Their Potential Impact

Restriction/Requirement	Not likely to expand outside TARP	Likely Influence on Future Practices	Likely Expansion Beyond TARP
Prohibition on Paying Bonuses			
Assessment of Risks in Incentive Plans			
Prohibition on Severance Payments			
Prohibition of Tax Gross-Ups			
162(m)(5) Deductibility Limit			
Claw Backs			
Say on Pay/Non-Binding Shareholder Vote			
Additional Disclosure of Perquisites/Luxury Expenditures			
Disclosure of Compensation Consultants			
Compensation Committee Governance Reqs			
Special Master of Compensation/Czar			

## Who Is Impacted?

- **Senior Executive Officers (SEOs)**
  - Five “Named Executive Officers” identified in proxy
    - » CEO, CFO and 3 most highly compensated executive officers
- **Highly Compensated Employees (HCEs)**
  - Employees (not necessarily executive officers) with highest “annual compensation”
  - Determined in last year completed as if employee was in proxy
- **“Annual Compensation” for determination of HCE status**
  - All columns in Summary Compensation Table (SCT), excluding pension and above market earnings
    - » Basically, salary, annual incentive/bonus, expense value of equity, perquisites and other compensation
  - Private companies use same rules
- **Different Restrictions Include Different Numbers of HCEs**
  - See chart on following page
- **Impacted Employees May Not Be Known Until End of Year**

## Who's Impacted: Snapshot

Restriction/Requirement	Who's Impacted
<b>Bonus restriction</b>	<\$25M = 1 HCE (1) \$25M - \$250M = 5 HCE (5) \$250M - \$500M = SEOs + 10 HCE (15) \$500M + = SEOs + 20 HCE (25)
<b>Golden parachute restriction</b>	SEOs + 5 HCE (10)
<b>Clawback</b>	SEOs + 20 HCE (25)
<b>Tax Gross-Up</b>	SEOs + 20 HCE (25)
<b>Risk Assessment – review of plans</b>	SEOs + all employees (unlimited)
<b>Luxury Expense Policy</b>	All employees (unlimited)
<b>Enhanced Perquisite Disclosure</b>	“Bonus HCEs” (1-25)
<b>162(m) Amendments</b>	SEOs (5)
<b>Special Master Review of EFAs</b>	“Bonus HCEs” (structure/levels) (1-25) 3b-7 officers + 100 HCEs (structure only)(100+)



# What Are the Restrictions/Requirements and What Do They Mean?

## ■ Bonus Limitations – General Rule

- **While TARP obligation exists, cannot pay or accrue**
  - Bonus
  - Retention
  - Incentive Compensation
- **Number of employees affected based on level of assistance**
  - < \$25M = the most highly compensated employee (1)
  - \$25M - \$250M = 5 most highly compensated employees (5)
  - \$250M - \$500M = CEOs + 10 most highly compensated employees (15)
  - \$500M + = CEOs + 20 most highly compensated employees (25)
- **Effective date: Payments or accruals after 6/14/09**
  - Implication: Awards accrued for 2008 performance probably can be paid
  - Example:
    - » Stock grant awarded on 2/20/09 with 3-year vesting
    - » Accrual permitted through 06/14/09
    - » Accrued amount can be paid out after restriction end (with 409A relief)
    - » Remainder prohibited unless fits under restricted stock exception

## ■ Bonus Limitations – What’s in and what’s out

### ■ What is prohibited

- Payments other than “regular rates of pay”
- Incentives rewarding performance over a specified period
- Stock and equity awards
  - » Exceptions for dollar amount denominated in cash and restricted stock caveat
- Sign on and new hire “make whole” packages
- SERP arrangements – if new or enhanced
- Loan forgiveness

### ■ What is not prohibited:

- Broad-based plan benefits
- Contributions to qualified plans
- Bona-fide overtime pay
- Routine expense reimbursements
- Deferred compensation plans if structured properly
- SERPS if accruals/credits not materially enhanced for significant period of time prior to restricted period

## ■ Bonus Limitations – Exceptions

### ■ Restricted Stock Exception

- No more than 1/3 of “annual compensation” for that year
  - » 50% of base salary for that year
    - Example: \$300,000 base salary + \$150,000 restricted stock = \$450,000 total annual compensation
- RS valued at FMV, rather than accounting value
- “Annual Compensation” for this purpose disregards prior year grant values
  - » Compare this to “Annual Compensation” for SEO/HCE determination
- Transferability restrictions
  - » At least 2 years (with exceptions for death, disability, CIC)
  - » In 25% increments corresponding to incremental TARP repayments
  - » Exceptions for amounts needed to pay taxes upon vesting

## ■ Bonus Limitations – Exceptions

- **Salary Paid as Stock**
  - Stock (or stock units) must be fully vested and determined at a value that accrues at the same time as regular salary payments
    - » Example: Instead of \$15,000/month salary, pay \$10,000 in cash and \$5,000 in stock units
  - Stock must be vested – no forfeiture attached
  - Implication: If increase in package is desired, best practice may be to payout in stock, with a sunset provision
- **Pre-Existing Contract Arrangements**
  - Payments under a “binding” employment contract in effect on 2/11/09
    - » Enforceable under that jurisdiction
    - » Material under 601(b)(10)(iii)(A) – many types of contractual arrangements
  - Cannot have material amendments to increase benefits after 2/11/09
  - Includes equity award agreement (e.g., stock option grant made on 2/10/09, even if subject to future vesting conditions)
  - Broader than pre-6/15/09 bonus payment exception because it covers portions accruing after 6/14/09

## ■ Bonus Limitations – Exceptions

### ■ Commissions

- Plans in effect on February 17, 2009 covering individuals similar to SEO or HCEs
  - » Unclear what updates to commission plans would be permitted
- Reflect sales to, and investment management services for, unrelated parties
  - » Broker-dealer, investment advisory, and insurance divisions where employees receive commissions based on amount of sales of financial products or value of assets under management
  - » Direct sale of products or services
  - » Where bonus payments are viewed more like salary
- Does not include
  - » Special deal or IPO-related transactions
  - » Fees earned from sales to entities within the affiliated group, investment banking, or proprietary trading

## ■ Bonus Limitations – Accruals

- **Granting of service credit towards calculation of the benefit or any vesting requirement**
- **Crediting compensation**
- **“Makeups” after TARP period for services performed or compensation received during the restricted period**
- **Multi-year awards that span TARP & non-TARP periods may be pro-rated**
  - Ex: 3-year award, with 1 year under TARP; company can pay 2/3 of award after TARP period
- **Anti-abuse rule: Can’t disguise incentive payment as increase in salary or stock option grant in a year not covered by TARP restrictions**
  - Treated as “accruing” during TARP coverage period

### *Broader Implications/Issues*

- *Not likely to expand beyond TARP participants*
- *Conflict with pay-for-performance*
- *Challenge for TARP banks is to continue to motivate and retain employees and drive high performance*
- *Accrual of 2008 incentives and bonus*

## ■ Risk Assessment Requirements

- **TARP participants are restricted from providing compensation that encourages “unnecessary or excessive risk” that threatens the value of the Company**
- **New rule extends requirement to ALL employee plans, not just executive plans**
- **Requires independent Compensation Committee to review and certify that plans do not motivate risk taking or encourage manipulation of earnings**
  - » Compensation Committee must be totally independent
  - » Must be established the later of 90 days after taking funds or 90 days after June 15, 2009 (i.e. September 14, 2009)
  - » Private companies receiving less than \$25M in funds - must either establish an independent Compensation Committee or designate full Board to serve in same role

## ■ Risk Assessment Requirements

### ■ Compensation Committee Requirements

- Must meet at least 2x per year with SRO(s) to evaluate, discuss and review
  - » SEO compensation plans to ensure they do not encourage SEOs to take excessive risks
  - » ALL employee compensation plans to ensure they limit risk taking
  - » Employee compensation plans to ensure they do not encourage manipulation of reported earnings to enhance compensation

### ■ Guidance for this process

- Understand business risks and how they are captured in incentive plans (short-and long-term)
- Identify terms of each plan and potential design features that could encourage excessive risk taking or pose risk to company
  - » Plans that place too much focus on short-term results rather than long-term value creation
  - » Pay programs with significant leverage; runaway incentives without caps
- Redesign plans as appropriate
- Document and certify

## ■ Risk Assessment Requirements

- **Annual Compensation Committee Certification**
  - In Compensation Committee Report of Proxy and to Treasury
  - Certify Committee has reviewed SEO and employee plans with SRO and made all reasonable efforts to ensure these plans do not encourage SEOs to take unnecessary risks that threaten value
  - Certify Committee has reviewed employee compensation plans to eliminate any features that would encourage manipulation of earnings
  - IFR provides template certification language
- **Disclosure**
  - Narrative description of each SEO compensation plan and how it does not encourage SEOs to take unnecessary risks
  - Identify each employee compensation plan, explain how any unnecessary risks have been limited, and explain how plan(s) does not encourage manipulation of earnings to enhance compensation
- **Private companies to provide certification and disclosure to primary regulatory agency and Treasury**

### *Broader Implications/Issues*

- *The SEC and Congress have expectations that all companies will review incentive plans and ensure they do not motivate unnecessary or excessive risk taking.*
- *While most companies do not have plans that would be motivate excessive risk taking, there are plan design features that will be considered best practice and will likely emerge across all industries.*

## ■ Prohibition on Golden Parachutes

- **SEOs and next 5 HCEs (10)**
- **No “golden parachutes” during obligation**
  - Payment for departure for any reason or any payment due to a CIC
    - » Includes acceleration of vesting
  - Eliminates the safe harbor (3x executive’s base amount) permitted under original CPP participation restrictions
- **Treated as paid at time of departure or CIC**
  - May include rights to amounts scheduled to be paid after TARP period

## ■ Prohibition on Golden Parachutes

### ■ Exceptions to the Prohibition

- Payments for services performed or benefits accrued
  - » Payments that would have been paid regardless of departure or CIC
- Certain payments from “benefit plans” and “deferred compensation plans”
  - » Plan must be in effect one year prior to departure
  - » Payments must be pursuant to plan that was not amended for one year before departure
  - » Employee has vested right under plan accrued only for periods of service employed
  - » Payments not due to discretionary acceleration within year prior to departure
  - » For deferred compensation plan, TARP recipient has previously recognized compensation expense or otherwise set aside assets in a trust
- Qualified pension or retirement plans
- Payments made due to death/disability
- Severance payments required by state or foreign law
- No exceptions for pre-existing severance plans or provisions in employment agreements (as opposed to bonus exception)

### *Broader Implications/Issues*

- *Prohibition not likely at non-TARP companies.*
- *However, more conservative severance packages may evolve*
- *Shareholder services groups don't support big severance packages that may motivate unnecessary or excessive risk taking.*
- *Sunset provisions emerging*

## ■ Prohibition on Gross-Ups

- **SEOs and 20 HCEs (25)**
- **No gross-ups corresponding to payment made or accrued during TARP period, even if payment occurs after the end of the TARP period**
- ***New guidance from ARRA – issued pursuant to Treasury’s extensive authority***

### *Broader Implications/Issues*

- *Already seeing reduction in gross-ups and acceptance declining*
- *Shareholder services groups like RMG vote against*

## ■ Claw Backs

- **Applies to CEOs and 20 HCEs (25)**
- **Requires recovery of bonus, retention award or incentive compensation based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate**
  - Employees who knowingly engage in providing inaccurate information (i.e., fraud)
  - “Materially” is facts and circumstances
  - Must be enforced unless unreasonable costs to do so
  - If material inaccuracy discovered after TARP funds repaid, the bonus payment still subject to claw back

### *Broader Implications/Issues*

- *Difficulty enforcing*
- *Reactive vs. proactive approach*

## ■ 162(m)(5)

- **162(m) officers (typically 5)**
- **Deduction limit cut to \$500,000 (from \$1M)**
- **Elimination of exceptions for**
  - Performance-based pay
  - Commissions
  - Grandfathered agreements
- ***No change from prior guidance under EESA***

### *Broader Implications/Issues*

- *Could emerge as a general practice*
- *Incentive for additional tax revenue while curbing excessive pay*

## ▪ Say on Pay

- **Required to submit non-binding shareholder vote to approve executive compensation**
- **Vote based on proxy disclosure (including the CD&A, the compensation tables, and any related material)**
- **Applicable for filers on or after 2/17/09**
- **First year takeaways**
  - Disclosure language is critical
  - Shareholder advisory firm votes affect results

### *Broader Implications/Issues*

- *Full attention of Congress and SEC*
- *Likely to be effective for all companies in 2010 or 2011*
- *Start preparing now*

## ■ Excessive or Luxury Expenditure Policy Requirement

- **Board must adopt and disclose policy on luxury expenditures (later of 90 days from closing or from 6/15/09 (i.e. 9/14/09) which must be:**
  - Provided to Treasury and primary regulatory agency
  - Posted on Company website
  - Amendments must be republished
- **Luxury expenditures include four categories of expenses that are not reasonable for staff development, performance incentives or in the normal course of business:**
  - Entertainment or events
  - Office and facility renovations
  - Aviation or other transportation
  - Similar items, events or activities
- **Policy must include**
  - Identification of expenses prohibited or requiring approval
  - Approval procedures where applicable
  - Certification by PEO and PFO that approvals were obtained
  - Prompt internal reporting of any violation of this policy
  - Accountability for adherence

## ■ Perquisites – Additional Disclosure

- **For each employee subject to bonus restriction (1-25) who receives more than \$25,000 in perks must disclose:**
  - Narrative description of the amount and nature of perks
  - Justification for the perquisite
- **Disclosure within 120 days of fiscal year-end to Treasury and primary regulatory agency**
- ***New guidance from ARRA -- pursuant to Treasury's extensive authority***

### *Broader Implications/Issues*

- *Heightened awareness and focus on excessive perks*

# Office of Special Master for TARP Executive Compensation

- **Appointed by The Secretary of Treasury**
  - Interpret and make determinations regarding regulations and applicable guidance
    - » TARP recipients may submit request for an advisory opinion
  - Review compensation paid before 2/17/09 at TARP companies and determine if contrary to public policy
  - Where appropriate will seek to negotiate reimbursement
- **Principles to be considered in Special Master review**
  - **Risk** – avoid incentives that reward for short-term rather than long-term value
  - **Taxpayer return** – reflect the need for the TARP recipient to repay the obligations
  - **Appropriate allocation** – represent a balanced mix of compensation (e.g. salary, short-and long-term incentive pay and current and deferred compensation or retirement pay)
  - **Performance-based compensation** – include tailored metrics that encompass individual performance and/or the performance of the company or business unit
  - **Comparable structures and payments** – consistent with, and not excessive, in comparison to those in similar roles at similar entities
  - **Employee contribution to TARP recipient value** – reflect the current or prospective contributions of the employee to the value of the company

# Office of Special Master for TARP Executive Compensation

- **At “Exceptional Financial Assistance” companies:**
  - Includes those in SSFI, TIP, AIFP and others designated by Treasury
    - » Currently includes AIG, Citigroup, Chrysler, Chrysler Credit, GM, GMAC and Bank of America
  - Review and approve payments and structures of employees subject to bonus restrictions
  - Review and approve structures for all other executive officers and next 100 HCEs
  - Authority to disapprove arrangement found to be inappropriate and require the Company to resubmit
  - Automatic approval if employee’s total compensation not more than \$500,000, with any additional compensation paid in form of qualifying long-term restricted stock.

## *Broader Implications/Issues*

- *Actions of Special Master will set precedent for all TARP participants and broader industry*

## ■ Compensation Consultant Disclosure

- **Increased Disclosure of Compensation Consultant Role**
- **Compensation Committee must provide to Treasury and primary regulatory agency a narrative description within 120 days of fiscal year-end**
  - Whether company, Board or Compensation Committee retained a compensation consultant
  - All types of services, including non-compensation related services provided by consultant or its affiliates to the company, the Board of the Committee in the past three years
    - » Includes any benchmarking to compare certain percentile levels of compensation (i.e., entities used for benchmarking and a justification for using these entities and the lowest percentile level proposed for compensation)
- ***New guidance to ARRA -- pursuant to Treasury's extensive authority***

### *Broader Implications/Issues*

- *Additional focus on compensation consultant disclosure likely*

- **If TARP target (T) acquired by non-TARP acquirer (A)**
  - A's employees not subject to rules
  - T's employees not subject to rules after transaction
- **Anti-abuse rule**
  - If purpose of transaction is to avoid rules, A treated as TARP recipient
    - » PEO and PFO of NewCo are SEOs
    - » T & A employees aggregated to determine HCEs

## ■ Certifications

- **Within 90 days after each fiscal year, PEO and PFO must provide certification that:**
  - Committee has:
    - » met with SROs 2x a year to discuss risk in SEO and employee compensation plans
    - » met with SROs 2x a year to identify features in employee compensation plan that could encourage manipulation of reported earnings to enhance compensation
    - » taken steps to limit features in SEO and employee compensation plans that could lead SEOs to take unnecessary risks
    - » certified these reviews
    - » provide narrative description of how it limited “risky” or “manipulative” features
  - Company has:
    - » compliant claw back, bonus, golden parachute, tax gross-up policy
    - » say on pay
    - » luxury expenditure policy
    - » complied with enhanced disclosure regarding perquisites
    - » provided proper disclosure regarding compensation consultants
    - » abided by agreement with Treasury
    - » provided a specific list of SEOs and 20 next highest paid, ranked in order of compensation
  - If receiving “exceptional financial assistance” – For executive officers + 100 most highly compensated employees (not subject to bonus restriction)
    - » Annual compensation is limited to \$500,000 or the compensation has been approved by Special Master
- **Certification on Exhibit 99.1 of 10-K**
- **Rules provide model language for first and subsequent year certification**
- **Must preserve certification for six years and keep first two easily accessible**

## ■ Even after debt repaid....

- **Bonus Payment Restriction**
  - Applies to amounts accrued during TARP period
- **Gross-Up Prohibition**
  - No gross-ups after TARP period in respect of taxable income during TARP period
- **Clawback**
  - May still occur after TARP period if bonus paid or promised during TARP period
- **Golden Parachute**
  - If employee departs during TARP period, no payment after TARP period
- **Risk Assessment/Compensation Committee Certifications/CEO & CFO Certifications/Perquisite & Consultant Disclosure**
  - Must be included for portion of last fiscal year before end of TARP period

## ■ Actions for TARP Participants

- **Understand employees affected by different requirements**
  - Actual impact not known until end of year (i.e. 2009 for 2010 compensation decisions)
- **Understand payback strategy/timeframe**
  - Different strategies
- **Conduct required risk assessment**
  - Executive AND employee programs
  - Incorporate into Compensation Committee meeting agendas
- **Model total compensation to determine impact during TARP period**
  - Determine restricted stock awards
  - Identify if other changes appropriate (within constraints)
- **Ensure luxury expenditure policy developed and posted**
- **Prepare for improved proxy disclosure and Say on Pay**
- **Ensure compliance and disclosure requirements met**

## ■ Actions for Non TARP Companies

- **Consider broader principles outlined by Administration as emerging best practices (see Client Alert 6/15/09)**
- **Review incentive plan design practices (executive and employee) to ensure they do not motivate and reward inappropriate risk taking**
- **Review employment contracts and consider emerging trends (e.g. gross ups) as renewals or new agreements put in place (i.e. grandfather)**
- **Prepare for Say on Pay – reflects decisions this year; consider disclosure impact**
- **Focus on CD&A/proxy – especially for Say on Pay vote**
- **Be prepared for new and expanded SEC disclosure requirements – expected soon**
- **Recognize that shareholders, media and public now have more information and greater voice in executive compensation**



# Thank You!

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Follow-up questions can be addressed to either of our speakers:

**Deborah Lifshey**  
**Managing Director**

**212 407-9519**

[deborah.lifshey@pearlmeyer.com](mailto:deborah.lifshey@pearlmeyer.com)

**Susan O'Donnell**  
**Managing Director**

**508 603-1493**

[susan.odonnell@pearlmeyer.com](mailto:susan.odonnell@pearlmeyer.com)

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