

Red Flags and Hot Topics in Bank Compensation

NYBA 2011 Senior Management Conference

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Regulatory Landscape

“Nothing focuses the mind like a hanging.” - Samuel Johnson

- Standards for Safety and Soundness (Regulation H) adopted by Federal banking agencies in 1995 (Section 39(c) of Federal Deposit Insurance Act)
 - Prohibits as an unsafe and unsound practice any employment contract, compensatory or benefits arrangement, and post employment benefits that provide excessive compensation or compensation that could lead to material financial loss to the institution
 - Applies to executive officers, employees, directors and principal shareholders
 - Requires regulator to determine when compensation is unreasonable or disproportionate to the services actually performed by the individual
 - Cornerstone of guiding principles and mandates enacted 15 years later



"Well what a coincidence! I'm a financial regulator too!"

- Banking Agency Guidance on Sound Incentive Compensation Policies adopted by the OCC, Federal Reserve, FDIC and OTS on June 25, 2010
 - Establishes 3 key principles for incentive-based compensation focused on processes that financial institution should adopt
 - Risk and financial performance should be in balance so that employees are not incentivized to take excessive risks
 - Compensation arrangements should be compatible with effective controls and risk management
 - Financial institutions should have governance structures in place to oversee and monitor compensation practices and effective oversight by board of directors
- Authority to regulate compensation is on-going as it is based on safety and soundness requirements of FDIA

- Golden Parachute Regulations (Feb 1996, FIL, Oct. 2010)
 - Prohibition against golden parachutes or any payment of severance to any institution-affiliated party (e.g., any employee) if the financial institution is designated as “troubled” (e.g., a composite rating of 4 or 5) without prior supervisory and FDIC approval (12 CFR Part 359)
 - Troubled institution must demonstrate:
 - » individual has not been involved in any misconduct that has had a material adverse effect on the institution
 - » the individual is not “substantially responsible” for the troubled condition of the institution
 - » the individual has not violated any applicable federal or state banking laws.

- New SEC compensation-related disclosure requirements for public companies
 - Item 402(s) of Regulation S-K (December 2009)
 - Explicit disclosure of compensation policies and practices if the compensation arrangements are reasonably likely to have a material adverse affect on the company.
 - Disclosure of material risk separate from Compensation and Disclosure Analysis
 - » Does not apply to smaller reporting companies

- Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted July 21, 2010 (DFR)
 - Wide-ranging financial reforms principally focused on the overhaul of the U.S. financial regulatory framework to avert future financial crisis
 - Dodd-Frank and implementing rules are an overlay on existing rules and regulations
 - Underlying premise of Dodd-Frank compensation provisions:
 - » Orientation of executive compensation towards long-term value creation and less on short-term risk taking
 - » Financial institutions currently lack robust policies and procedures to deal with incentive-based compensation decisions
 - Reaffirms compensation principles and guidance previously enunciated in 39(c) of FDIA and Bank Agency Guidelines
 - » Covered financial institutions are barred from establishing or maintaining any type of incentive-based compensation that could lead to material loss to the institution
 - Rules are principles-based (not rule based) thus lack specificity
 - » Standards will be enforced through examiner leverage

Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted July 21, 2010 (DFR)

Regulations in Four Broad Categories

Enhanced Pay Disclosure

- Pay versus Performance
- Internal Pay Equity Ratio
- Hedging Policies

Additional Listing Standards

- Expansion of Independence Requirement of Compensation Committee
- Selection and Funding of Compensation Advisors
- Recovery or Erroneously Awarded Compensation

Shareholder Empowerment

- Shareholder Say on Pay
- Disclosure of and Shareholder Vote on Golden Parachutes

Incentive-Based Compensation Arrangements

- Disclosure of the Structure of all Incentive-Based Compensation Arrangements
- Prohibits any Incentive-Based Compensation that Encourages Inappropriate Risk-Taking

Current Status of Proposed Regulations Under Dodd-Frank

Provisions	Status of Rule-Making
Say on Pay	<ul style="list-style-type: none"> • Final rules adopted by SEC on January 25, 2011 • Effective 1st shareholder meeting on or after January 21, 2011 • Delayed compliance for smaller reporting companies until January 21, 2013
Say on Golden Parachutes	<ul style="list-style-type: none"> • Final rules adopted by SEC on January 25, 2011 • Effective for proxy statements filed on or after April 25, 2011 • No delayed exemption for small reporting companies
Pay vs Performance Internal Pay Equity Ratio Hedging Policies	<ul style="list-style-type: none"> • Issuance of proposed rules delayed until August –December 2011
Compensation Committee Independence & Authority Compensation Committee Advisors	<ul style="list-style-type: none"> • SEC issued proposed rules on March 30, 2011 • Comment period ended May 19, 2011; planned adoption of final rules sometime between August – December 2011 • Disclosure requirements regarding use of compensation consultants effective 1st annual meeting on or after July 21, 2011
Clawback Policies	<ul style="list-style-type: none"> • SEC guidance originally scheduled for April to July 2011, now scheduled for August to December 2011 • National exchanges/ associations then issue their own guidance • Final rules not expected until 2012 proxy season
Special Rules for Covered Financial Institution on Incentive-Based Compensation Arrangements	<ul style="list-style-type: none"> • Inter-agency banking regulations issued April 14, 2011 • Comment period ended May 31, 2011 • Planned adoption of final rules late 2011 or early 2012

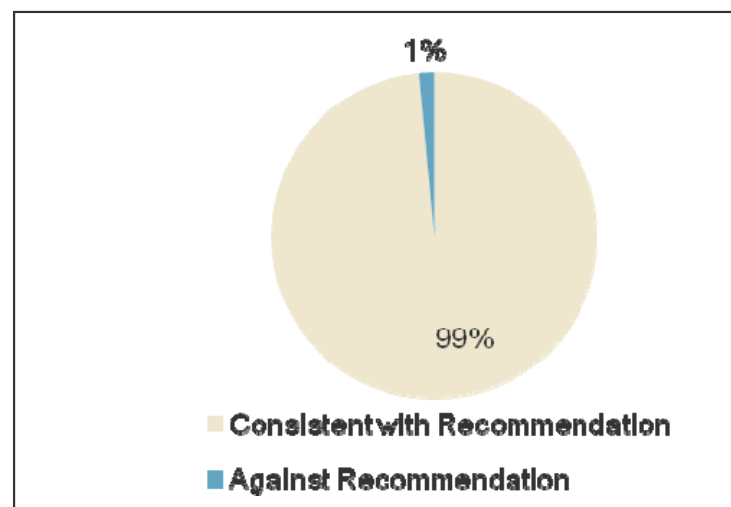
Say on Pay Voting Summary

Say on Pay Voting Summary (as of June 2, 2011)

- Out of the 2,179 companies that have disclosed SOP vote results, 99% voted in favor of the SOP proposal and 1% voted against
- So far this year, 29 companies have lost their SOP vote (no banks!):
 - Ameron International Corp.
 - Hewlett Packard, Inc.
 - Penn Virginia Corp.
 - Beazer Homes
 - Intersil Corp.
 - Pico Holdings Inc.
 - Biomed Realty Trust Inc.
 - Jacobs Engineering Group, Inc.
 - Shuffle Master Inc.
 - Cincinnati Bell Inc.
 - Janus Capital Group, Inc.
 - Stanley Black & Decker Inc.
 - Constellation Energy Group Inc.
 - Kilroy Realty Corp.
 - Stewart Information Services Corp.
 - Cogent Communications Group Inc.
 - Masco Corp.
 - Superior Energy Services Inc.
 - Curtiss Wright Corp.
 - MDC Holdings Inc.
 - Talbots Inc.
 - Dex One Corp.
 - Navigant Consulting Inc.
 - Umpqua Holdings Corporation
 - Helix Energy Solutions Group, Inc.
 - Nutri System Inc.
 - Weatherford International Ltd.
 - Hercules Offshore, Inc.
 - NVR Inc

General Industry

	#	%
SOP Votes:	2,681	
SOP Vote Results:	2,179	81%
SOP Votes		
Consistent with Recommendation	2,150	99%
Against Recommendation	29	1%



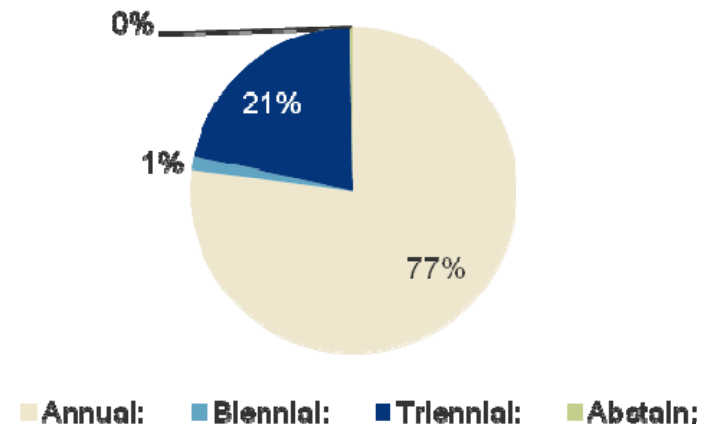
(1) Data results based on companies filing proxies between December 2, 2010 and June 2, 2011

Say on Frequency Voting Summary (as of June 2, 2011)

- Out of the 2,029 companies that have disclosed SOF vote results, 77% resulted in annual, 21% resulted in triennial and 1% resulted in biennial voting frequency
- Out of the 496 Financials Sector companies that have disclosed SOF vote results, 74% resulted in annual, 23% resulted in triennial and 2% resulted in biennial voting frequency

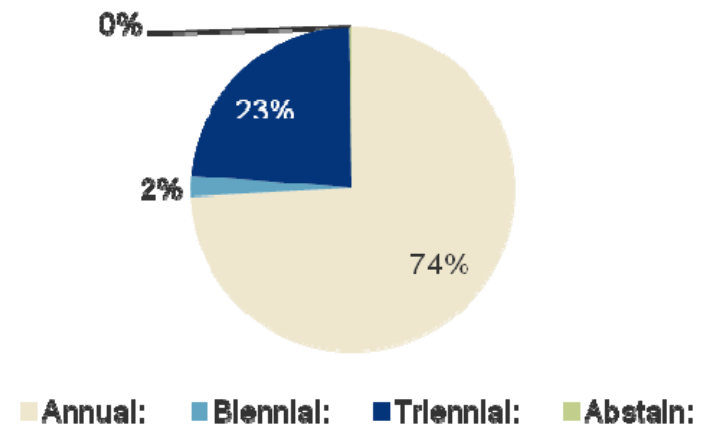
General Industry

	#	%
Say on Frequency Votes:	2681	
Say on Frequency Vote Results:	2029	76%
Votes for		
Annual:	1561	77%
Biennial:	27	1%
Triennial:	435	21%
Abstain:	6	0%



Financials

GICS Sector:	40	
	#	%
Say on Frequency Votes:	764	
Say on Frequency Vote Results:	496	65%
Votes for		
Annual:	368	74%
Biennial:	11	2%
Triennial:	116	23%
Abstain:	1	0%



(1) Data results based on companies filing proxies between December 2, 2010 and June 2, 2011

Impact on Incentive Compensation Plans – Risk Management & Assessment Perspective

Overview of Bank Regulator Guidance

- New proposed regulations expand on the Agency guidance to implement and enforce Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act
- The intent is to control risk related to the use of incentive compensation arrangements (ICAs) for employees at covered financial institutions

Agency Guidance – June (FRB, FDIC, OTS, OCC)

- Effective June 25, 2010
- Impacts all financial institutions
- Principles-based guidance
- Three principles:
 - Design features should mitigate risk taking
 - Effective controls
 - Strong corporate governance
- Size and complexity of institution and ICAs considered
- Covered individuals:
 - Senior executive officers
 - Individual employees whose activities may expose the institution to material risk
 - Groups of employees who in the aggregate may expose the institution to risk

FDIC Proposal – February (FRB, FDIC, OTS, OCC, NCUA)

- In comment period
- Impacts institutions > \$1b
- Prohibition of ICAs to Covered Persons that encourage inappropriate risk by:
 - Providing excessive compensation; or
 - Creating a potential for material financial loss
- Requires annual reports to appropriate regulator(s) of the structure of ICAs
- Requires policies and procedures for ICAs that are commensurate with the size and complexity of the institution
- Special rules for institutions with assets greater than \$50 billion
 - Mandatory deferral of a substantial portion of ICAs to executive officers
 - Enhanced internal review and approval of ICAs for other individuals who have the ability to expose the institution to significant loss

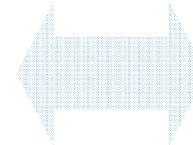
LOWER RISK

HIGHER RISK

MIX

At least half of compensation in base salary
 Most of compensation paid based long-term, sustained performance

Majority of compensation in incentive pay
 Most of compensation paid based on annual, short-term results

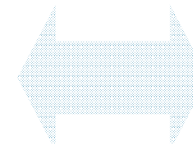


MEASURES

Balance of performance measures:

- Financial, operational, quality
- Short and long-term
- Bank and Individual
- Absolute and relative
- Formula and discretion

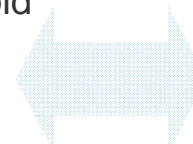
1 (or few) performance measures
 1 (or few) performance perspectives (e.g. all top line metrics without accounting for quality)
 Same performance measures used for short and long-term incentives



DESIGN FEATURES

Cap/maximum payout
 Appropriate performance-payout curve
 Multi-year performance period (or hold back/deferral if focus on short-term)
 Discretion allowed
 Claw back
 Ownership/holding requirements

No cap/unlimited upside
 Threshold/target set too high
 Quarterly or single year performance without some focus on longer-term
 Formulaic calculation
 No claw back
 No ownership/holding requirements

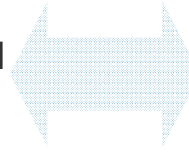


LOWER RISK

HIGHER RISK

GOAL SETTING

Centralized review process for approving goals
Realistic goals considering historical and projected performance
Performance goals adjusted for risk



Decentralized process for approving goals
Unrealistic goals and/or goals that are not aligned with historical and/or projected performance
Performance goals are not adjusted for risk

CONTROLS AND GOVERNANCE PROTOCOLS

Robust process to review and approve plan designs AND payouts
Compensation Committee/Executive management reviews and approves the range of potential payouts (i.e. scenario test)
Guidelines and approvals are in place for adjusting results as appropriate



No centralized process in place to review and approve plan designs OR payouts
Compensation Committee and/or Executive management do not understand the full range of potential payouts

Clawbacks

“Americans will always do the right thing...After they’ve exhausted all the alternatives.”

Winston Churchill

■ Clawbacks Under New York Common Law

- Repayment or forfeiture of compensation due to executive misconduct has long been part of NY common law under “faithless servant” doctrine
 - Remedy grounded in agency law
 - Employee has fiduciary duty of loyalty, good faith and disclosure
 - Employee is prohibited from acting in any manner inconsistent with the purposes of the employer
 - Common law remedy generally is not available for breach of duty of care involving errors of judgment or negligence
 - Remedy can be used as a “sword” to recoup amounts paid or as a “shield” to deny payment of compensation otherwise due



Artist Rex May Baloo

■ Clawbacks in Employment Agreements

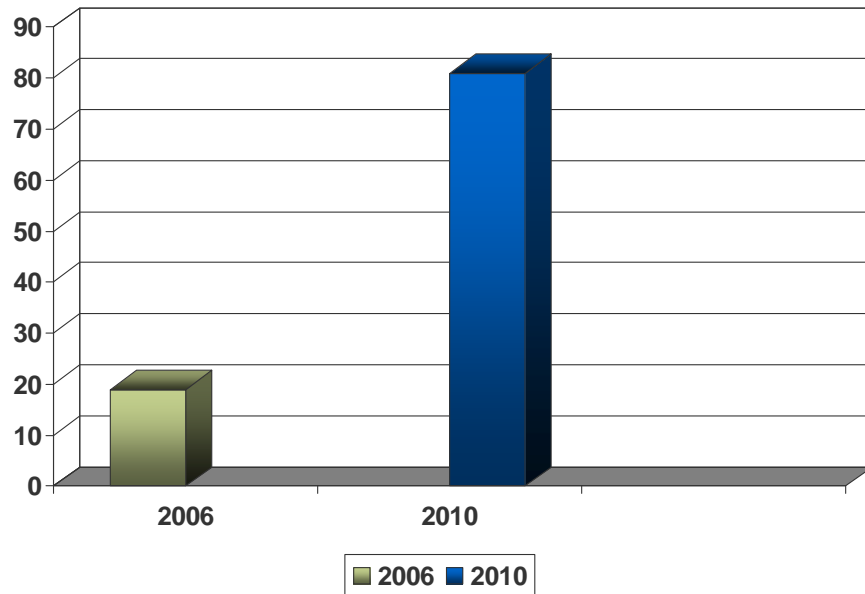
- Provisions in employment, severance or change-in-control agreements that allow the company to withhold or recoup from the executive some or all of bonus or other incentive compensation paid as a result of executive's misconduct
 - Violation of non-compete
 - Ethical violations; conflict of interests
 - Termination of employment for "cause"
 - Commission or conviction of a felony
 - Actions that reflect negatively on the company, e.g., sexual harassment
 - Direct participation in the preparation of false financial statements or involvement in other fraudulent activity

■ Federally-Legislated Clawbacks: SOX

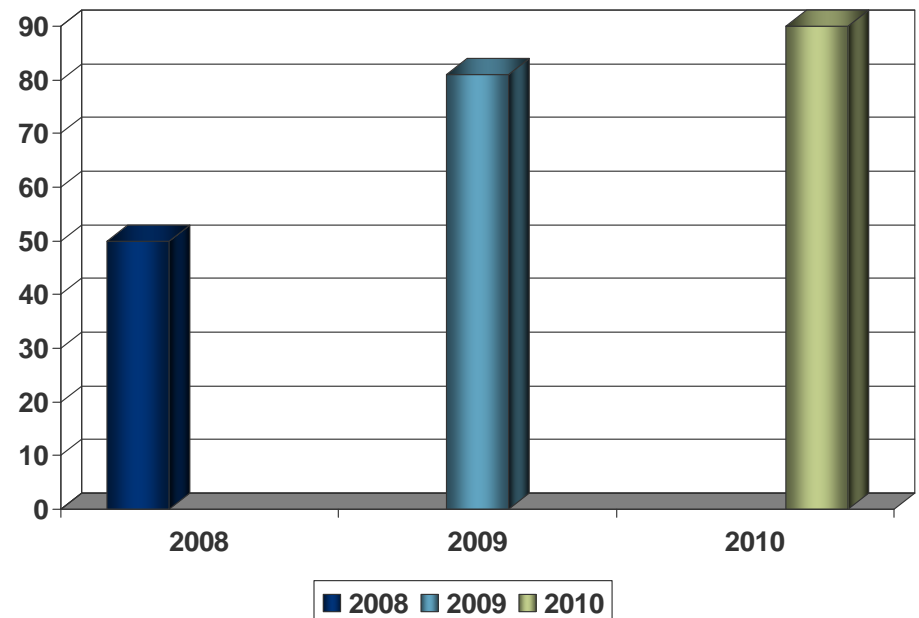
- Sarbanes-Oxley Act - Section 304
 - Requires disgorgement by CEO and CFO of compensation for violations of federal securities laws involving financial reporting
 - Triggered by an accounting restatement due to the material noncompliance of financial statements due to misconduct
 - » Clawback supposed to be self-executing; CEO and CFO have obligation to pay back bonuses, other incentive compensation received during the 12 months after the first public issuance or filing of the document, whichever occurs first, that embodies the erroneous financial data; and
 - » Return any profits from the sale of securities
 - » If CEO or CFO doesn't reimburse the company, SEC can bring an enforcement action against the CEO or CFO for violating that obligation

Recent Rise in Corporate Clawback Policies

Fortune 100 companies with clawback policies



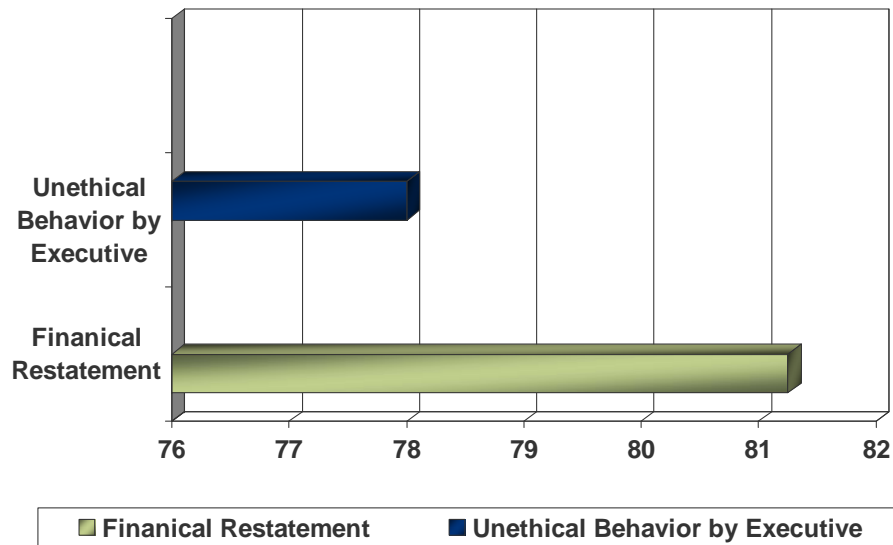
Fortune 100 Financial, Insurance and Real Estate Companies with Clawback Policy



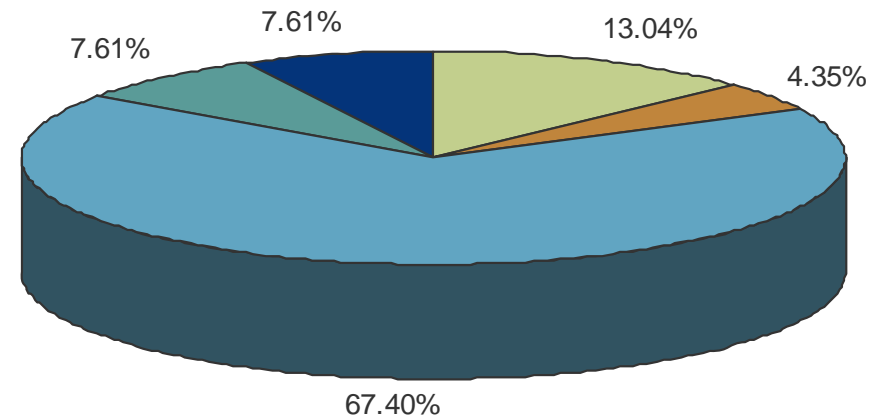
Source: Equilar 2010 Clawback Policy Report

Recent Rise in Corporate Clawback Policies

Provisions of 2010 Clawback Policies



Fortune 100 Financial, Insurance and Real Estate Companies with Clawback Policy



- All Employees
- Directors and Employee Category
- Key Executive / Employees Only
- Named executive Officers Only
- Other

Source: Equilar 2010 Clawback Policy Report

■ Federally-Legislated Clawbacks: Dodd-Frank

- Dodd-Frank co-exists with SOX, but different and expanded clawback
 - Companies must disclose their policies on incentive-based compensation that is awarded based on financial information required to be disclosed under federal securities law
 - SEC is required to direct national securities exchanges and associations (NYSE and Nasdaq) to prohibit the listing of any company that does not adopt and enforce a clawback policy to recover, in the event of a restatement of the financial statements, the excess incentive-based compensation that was determined on the basis of materially inaccurate information and that was paid to any current or former executive officer during the three-year period preceding the restatement



Comparison of Clawback Under SOX, TARP, Dodd-Frank

	SOX	TARP-ARRA	Dodd-Frank
Institution Covered:	Public	<i>Institution receiving TARP funds Public and non-public</i>	Public
Individuals Covered:	CEO and CFO	<i>5 CEOs and next 20 most highly-compensated</i>	All executive officers. (See Section 16 and Rule 3b-7 of Exchange Act for guidance)
Trigger	Accounting restatement as a result of misconduct CEO and CFO subject to clawback even if not personally liable (SEC v. Jenkins)	<i>Recovery required if statement of earnings, revenue, gains or other criteria turn out to be materially inaccurate Misconduct not required Restatement required</i>	Accounting restatement No misconduct required
Clawback Amount	Incentive compensation and profits from sale of stock received during 12-month period following filing/ issuance of inaccurate financial statement	<i>Clawback applicable during period financial assistance remains outstanding Bonus retention awards, incentive compensation Does not require clawback of profits from sale of stock</i>	Any incentive-based compensation (including stock option awards) that is (i) based on “erroneous data”, and (ii) received during the 3-year period preceding the date on which the company becomes required to prepare an accounting statement, and (iii) in excess of what would have been paid if calculated under the restatement

Adapting to the Current Environment - Public Companies

- Public companies should take “wait and watch” approach until regulations are promulgated by the SEC and guidance is issued by the national exchanges and national associations
- Preliminary Steps
 - Review compensation committee’s charter to determine that the committee has the authority necessary to adopt and implement a clawback policy
 - Conduct an inventory of clawback provisions in all existing agreements (employment, severance, change in control) currently in place with current and former executives
 - Determine the scope of the clawback policy - should it be consistent with SOX, Dodd-Frank or apply to all incentive compensation eligible-employees (a much broader approach that has been adopted by some financial institutions)

Adapting to the Current Environment - Public Companies (continued)

- Determine the appropriate internal personnel to be involved in the process of designing, monitoring incentive-based compensation plans: Risk Management, Finance, HR, etc.
- Begin compiling information necessary to analyze whether compensation could be deemed “excessive” under Section 39(c) factors

Adapting to the Current Environment - Non-Public Companies

- Non-public companies should consider whether adopting a clawback policy would be consistent with bank's current compensation structure
- Does the compensation committee currently have a clear and well-defined "pay for performance" philosophy
- Is the philosophy born out in the company's compensation policies, programs and decision-making
- How would a clawback policy fit into the bank's pay for performance paradigm and shareholder sentiments

Adapting to the Current Environment - Non-Public Companies (continued)

- Determine the kind of compensation that will be affected - most popular approach is to include all performance-based awards, including both short-term and long-term (with performance periods of more than one year)
- Determine the circumstances that would trigger the clawback of erroneously paid compensation
 - » “No-fault” policy: when accounting errors reach the level of “materiality” requiring a restatement of financial statements regardless of misconduct
 - Individuals required to disgorge amounts paid to them based upon performance targets that were not actually achieved, or

Adapting to the Current Environment - Non-Public Companies (continued)

- Modified No-Fault: clawback enforced only when the restatement does not result in a significant change to the company's overall financial results
- Review indemnification arrangements, D&O policies, to determine whether executive can be advanced/reimbursed for attorneys fees in the event of a challenge to a clawback dispute arising from a no-fault restatement
- Assessment of executive compensation is part of management evaluation in the CAMELS examination, how would a clawback promote bank's compliance with the Interagency Banking Guidelines
- Determine the impact of New York State Labor Laws (Section 193 and 198) on the enforceability of a clawback

Key Areas to Focus in Light of New Regulations

GOVERNANCE

Key Area	Impact	What to Do Now
<i>Governance Structure and Practices</i>	<i>All public companies but best practice for all organizations</i>	<ul style="list-style-type: none"> ■ Clarify rationale if combined Chair/CEO role ■ Consider Lead Director if employee Chair ■ Review and update charters to ensure they reflect emerging requirements and responsibilities (e.g. risk assessment) ■ Be prepared to develop/enhance claw back policy in line with requirements
<i>Independence Standards (Compensation Committee/ Consultant)</i>	<i>All Companies</i>	<ul style="list-style-type: none"> ■ Assess Compensation Committee independence (assume Audit Committee standard pending SEC rules) ■ Ensure Compensation Committee has authority (and funding) to retain advisors that report directly to the Committee ■ Assess your consultant/advisor independence
<i>Shareholder Influence</i>	<i>Public Companies</i>	<ul style="list-style-type: none"> ■ Understand and address potential shareholder issues - consider increased outreach in light of Say on Pay ■ Assuming proxy filed already, review shareholder say on frequency vote and determine approach going forward ■ Identify potential shareholders eligible for proxy access to assess potential impact

■ Dodd Frank: Key Areas to Focus on Now


COMPENSATION

Key Area	Impact	What to Do Now
<p><i>Say on Pay/ Say on Frequency/ Say on Golden Parachutes</i></p>	<p><i>All Public Companies</i></p>	<ul style="list-style-type: none"> ■ Understand perspective of shareholder advisory firms (e.g. ISS, Glass Lewis) ■ Understand impact of no broker vote ■ Enhance proxy disclosure in line with new expected/best practices – tell the “story”; pay for performance alignment is key
<p><i>Incentive Compensation Arrangements and Risk</i></p>	<p><i>All Companies</i></p>	<ul style="list-style-type: none"> ■ Build on risk assessment begun in 2010 and further refine processes used for evaluating risk ■ Develop appropriate documentation, procedures, incentive plan features to mitigate risk ■ Compensation Committee should understand all incentive plans to ensure compliance with risk requirements
<p><i>Disclosure/ Reporting</i></p>	<p><i>Public Companies</i></p>	<ul style="list-style-type: none"> ■ Clarify/communicate compensation philosophy ■ Ensure CD&A tells a clear story, particularly regarding pay-performance ■ Assess and monitor pay-for-performance alignment ■ Have perspective on internal pay relationships

■ Compensation Practices: Focus on Long-Term Horizon

- Compensation practices should be adjusted to:
 - Consider risk horizon and timeframe of results/rewards
 - » If results not known for several years – timing for reward should not be based on one year
 - Place more focus on longer term, sustainable performance
 - » Adjust the “mix” of total compensation to focus more on long-term performance; enhance long-term incentive timeframes/vesting
 - Ensure reward periods match the timeframe required to determine whether a decision/action was successful
 - » If not, change design features to allow for better alignment
- Short-term incentive techniques
 - Holdbacks/deferrals – portion of annual award contingent on sustained future performance
 - Payment in stock – pay part (or above target) payouts in stock
 - Shifting mix to long-term (can be cash for mutuals/private banks)
- Long-term incentive techniques
 - Extended vesting of awards (i.e. longer multi-year periods)
 - Performance vesting of restricted stock
 - Stock ownership and retention guidelines
 - Hold until or past retirement requirements

- A complex balancing act
 - Economic environment
 - Influences out of control of management (e.g. stock price, rates)
 - Optics and perceptions - media/public/shareholders
 - Disclosure limitations
 - Regulatory mandates
 - Piecemeal view
- Assess pay-performance relationship
 - Review one and three year trends
 - Relative to internal goals and peers/industry
- Stress test to understand potential range of outcomes for performance and pay
 - Do you know the maximum payout/total compensation that can result under compensation programs?
 - Is the payout leverage appropriate (i.e. does incremental performance result in appropriate incremental pay and vice versa)?
 - What is the share ratio of pay-performance?



Increased disclosure will drive increased scrutiny

■ In Summary...

- ✓ Review and Define Your Governance and Risk Controls
 - Review governance practices in light of pending legislation (independence, process, disclosure)
 - Clarify roles of management, Compensation Committee, Board
 - Establish process for assessing risk and ongoing compliance
 - Clarify/define your compensation philosophy
 - Develop/enhance claw back policy and procedure for incentive programs

- ✓ Review Compensation Program and Incentive Plans
 - Review current programs to determine whether they support desired philosophy going forward
 - Review incentive plans in particular to ensure they do not motivate and reward inappropriate risk taking
 - Ensure compensation program supports long-term view of performance
 - Ensure total compensation program embraces balance and is aligned with both company business strategy and shareholder interests

■ In Summary...

- ✓ Ensure “best practice” related to severance & CIC provisions
 - Double triggers
 - Board flexibility to determine best outcome for shareholders rather than automatic accelerated vesting upon a CIC
 - Draft CIC agreements to provide that outstanding shares granted under equity plan can be assumed, converted, or substituted at the discretion of the board

- ✓ Continue to Stay Informed
 - Regulations are constantly changing
 - Past practice is NOT best practice
 - New set of lenses

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