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THE TARP EXECUTIVE COMPENSATION STANDARDS – A SIGN OF THINGS TO COME?

Executive compensation guidance for TARP participants issued by Treasury in June to implement congressional acts expands the number of covered employees, imposes stricter limits on certain compensation payments, and adds new corporate governance requirements. The author reviews these developments and suggests that certain of them are likely to become general practice in the corporate community.

By Mark A. Borges *

As the impact of the global financial crisis continues to reverberate throughout the United States' economy, one of the principal outcomes of the federal government's response to the problems in the financial sector is likely to involve the reform of the present system for setting executive compensation. Where, in the past, efforts to reform executive pay have been incremental and reactive in nature (and, as a result, often ineffective), the breadth and scope of the current crisis – coupled with the unprecedented public outrage over the compensation practices that ostensibly fueled the crisis – have created an opportunity for real reform.

With both the Obama Administration and Congress in the process of considering legislation to address the future of executive compensation, speculation is underway as to the extent of these reforms. And while there are numerous examples of prior legislative proposals aimed at curbing executive pay abuses to draw from,[1] it is likely that any reform initiative will take into account the executive compensation standards that have been imposed on financial institutions and other companies receiving government assistance over the past year. With that in mind, this article summarizes these new executive compensation standards, as recently amplified by guidance from the Department of the Treasury, and assesses their chances for application to the broader corporate community.

EESA'S EXECUTIVE COMPENSATION STANDARDS

The Emergency Economic Stabilization Act of 2008[2] ("EESA"), which was signed into law by then-President Bush on October 3, 2008, was designed to provide a massive capital infusion to financial institutions overwhelmed with excessive levels of mortgage-backed and related securities and to restore liquidity and stability to the United States financial markets. Pursuant to EESA, the Department of the Treasury established the Troubled Asset Relief Program ("TARP") to facilitate these objectives by acquiring or guaranteeing the

[1] *E.g.*, S. 2866, the "Corporate Executive Compensation Accountability and Transparency Act," which was introduced in the 110th Congress by Senator Hillary Clinton (D-NY).

[2] Public Law 110-343 (October 3, 2008); 12 U.S.C. §5021 *et seq.*

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"troubled assets" of these institutions.[3] As a condition of participation in the TARP, financial institutions receiving government funds were required to comply with a number of specified executive compensation standards during the period that Treasury held an equity or debt position in the institution.[4]

Generally, these standards were to apply to a financial institution's "senior executive officers" ("SEOs"). For these purposes, these are the individuals who, in the case of a public company, are among the top five most highly paid executives who are required to have their compensation disclosed pursuant to the Securities Exchange Act of 1934[5] (including the principal executive officer and principal financial officer), or their non-public company counterparts.[6]

While the introduction of legislatively adopted executive compensation "standards" would be significant under any circumstance, these requirements were particularly noteworthy as they represented an effort to legislate the "substance" (rather than just the "process") of executive pay. Previously, congressional efforts to influence executive pay have been largely indirect, involving either enhanced transparency around the compensation-setting process or the use of the Internal Revenue Code to penalize certain behaviors.

SUBSEQUENT TREASURY GUIDANCE

On February 4, 2009, Treasury issued new guidance on the EESA executive compensation standards, essentially dividing TARP participants into two categories: financial institutions receiving so-called "exceptional assistance" and financial institutions participating in Treasury's "generally available capital access programs."[7] This guidance was, in part, a response to criticism that Treasury had no means for monitoring compliance with the standards and holding accountable institutions that failed to abide by them.

The February 2009 Treasury Guidance had two objectives. First, it established reporting and recordkeeping requirements on TARP participants to ensure compliance with the standards, including an annual certification requirement. In addition, the guidance sought to establish two levels of regulation: institutions receiving exceptional assistance were to be subject to more rigorous executive pay standards than those participating in the generally available capital access programs.[8] Financial institutions receiving exceptional assistance would have to:

- limit the total compensation (excluding restricted stock or similar long-term incentive compensation

[3] §101(a) of EESA.

[4] These standards were set forth in Section 111 of EESA and supplemented by Treasury regulations for financial institutions participating in the Capital Purchase Program that were published in the Federal Register on October 20, 2008. TARP Capital Purchase Program, Interim Final Rule 31 CFR Part 30 (the "October 2008 Interim Final Rule"); Treasury Notice 2008-TAAP (providing guidance on the provisions of Section 111(c) of EESA applicable to financial institutions participating in auction programs for the purchase of troubled assets); Treasury Notice 2008-94 (addressing certain tax provisions in Section 302 of EESA applicable to SEO compensation); and Treasury Notice 2008-PSSFI (providing guidance on the provisions of Section 111(b) of EESA applicable to financial institutions participating in programs for systematically significant failing institutions (which were subsequently amended on January 16, 2009)).

[5] 15 U.S.C.§78a *et seq.* (2008).

[6] §111(a)(1) of EESA.

[7] Department of the Treasury Press Release No. TG-15, "Treasury Announces New Restrictions on Executive Compensation" (February 4, 2009).

[8] For these purposes, "exceptional assistance" meant an increased level of financial assistance that was more than the amount allowable under a generally available program (such as Treasury's Capital Purchase Program). Examples of financial institutions falling into this category included American International Group, Citibank, Inc., and the Bank of America. A "generally available capital access program" meant a program having uniform terms for all participants, as well as limits on the amount each institution may receive, and specified returns for taxpayers (such as the Capital Purchase Program and the Capital Assistance Program).

arrangements) of their SEOs to no more than $500,000 annually;

- provide that any restricted stock awarded to the SEOs be non-transferrable while the institution was still a TARP participant;

- conduct an annual shareholder advisory vote on executive compensation;[9]

- adopt a policy requiring the mandatory recovery of any bonus or incentive compensation paid to an SEO if the payment was based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate (a so-called "clawback" policy);[10]

- agree not make any type of severance payment to their SEOs and the next five senior executives, and limit severance payments to the next 25 executives to no more than one year's compensation; and

- adopt a company-wide policy potentially limiting expenditures on aviation, facility renovations, entertainment and parties, and conferences.

Financial institutions receiving assistance through a generally available capital access program would have to:

- agree to limit the total compensation (excluding restricted stock) of their SEOs to no more than $500,000 annually, unless the institution agreed to make full public disclosure of its executive compensation and conduct an annual shareholder advisory vote on executive compensation;

- adopt a clawback policy requiring the mandatory recovery of any bonus or incentive compensation paid to an SEO if the payment was based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate;[11]

- agree to limit severance payments to their SEOs to no more than one year's compensation; and

- adopt a company-wide policy potentially limiting expenditures on aviation, facility renovations, entertainment and parties, and conferences.

The February 2009 Treasury Guidance was not intended to be retroactive in its application to either existing investments or to assistance programs that had already been announced. However, before regulations implementing these restrictions could be issued, the American Recovery and Reinvestment Act of 2009 ("ARRA") was passed.[12] Although there was no official announcement by Treasury at that time as to the implications of this development on the February 2009 Treasury Guidance, Treasury subsequently removed the publicly available version of the guidance from its website.

ARRA'S REVISION OF THE STANDARDS

The executive compensation standards of EESA were subject to criticism from all quarters – by TARP participants for their harsh restrictions and vagueness, by investors for their limited scope, and by the public for their perceived inability to stem a series of pay-related scandals that were exposed in the following months. As a result, the enactment of ARRA led to the wholesale amendment and expansion of the standards in ways that differed from the February 2009 Treasury Guidance.[13]

Among other things, ARRA expands the number of individuals covered by the original EESA compensation standards, imposes stricter limits on certain types of compensation payments, and adds new corporate governance requirements, such as the formation of a board compensation committee and an annual CEO/CFO certification, to ensure compliance with the standards. EESA provides for the Secretary of the Treasury to conduct a review of all bonuses, retention awards, and other compensation paid to a TARP participant's SEOs and its next 20 most highly compensated employees (as in place before the date of enactment of ARRA) to determine whether any such payments are inconsistent

[9] This vote was also to include full disclosure of the institution's executive compensation structure and strategy and an explanation of how the TARP participant's executive compensation program was linked to sound risk management.

[10] In addition, this clawback policy would have extended to the institution's next 20 executive officers if the bonus or incentive compensation was based on materially inaccurate financial statements or performance criteria, *and* the subject executive officer had knowingly engaged in providing inaccurate information relating to those financial statements or performance criteria.

[11] *See* note 10, *supra.*

[12] Public Law 111-5, Title II, 110 Stat. (2009).

[13] §7001 of ARRA. Except as noted, references hereinafter to EESA are to EESA, as amended by ARRA.

with the purposes of the executive compensation standards or the TARP or were otherwise contrary to the public interest. If the Secretary makes such a determination, he is required to seek to negotiate with the TARP participants and the subject employee for appropriate reimbursements to the federal government with respect to the compensation or bonuses.[14] In June 2009, the Secretary delegated this responsibility to the Office of the Special Master for TARP Executive Compensation, run by Kenneth Feinberg. Since then, Feinberg has spent most of his time overseeing the development of the compensation programs for the seven companies that have received "exceptional assistance."

As amended, the standards apply during the period that any obligation arising from the financial assistance provided under the TARP remains outstanding.[15] Further, ARRA required Treasury to promulgate regulations to implement the amended standards and authorized the Secretary of the Treasury to establish additional appropriate standards for executive compensation and corporate governance as he determines.[16]

Notably, ARRA requires that a TARP participant's chief executive officer and chief financial officer (or the holders of equivalent positions) certify in writing each year that the recipient has complied with the new standards.[17] In the case of a TARP participant that is a public company, these certifications are to be provided to the SEC as part of its annual filings under the federal securities laws.[18] If the TARP participant is not a public company, the certifications are to be provided to its primary regulatory agency and to Treasury.[19]

JUNE 2009 TREASURY GUIDELINES

By its terms, ARRA appeared to apply the revised executive compensation standards (with one notable exception)[20] only upon the issuance of implementing regulations by Treasury.[21] On June 10, 2009, Treasury issued new regulations providing guidance on the executive compensation standards of EESA.[22] Among other things, this guidance implements the ARRA provisions, consolidates all of the executive compensation-related provisions specifically directed at TARP participants into a single rule, and uses the discretion granted to the Secretary of the Treasury to adopt additional standards.[23] To facilitate compliance, the guidance is presented in a question and answer format. References to the questions are to this guidance.

IMPLICATIONS OF THE STANDARDS

While the revised standards apply only to financial institutions receiving assistance under the TARP,[24] for a

[14] EESA § 111(f); TARP Standards for Compensation and Corporate Governance, Interim Final Rule 31 CFR Part 30 (the "June 2009 Interim Final Rule") §30.16 Q-16 ("What is the Office of the Special Master for TARP Executive Compensation, and what are its powers, duties and responsibilities?").

[15] As currently mandated, the requirements of §111(b) of EESA apply only during the period in which any obligation to the federal government arising from the financial assistance provided under the TARP remains outstanding (*e.g.*, §111(b)(3)(B) of EESA). The requirements of §111(c) and (d) of EESA apply through the later of (i) the last day of the period during which any obligation to the federal government arising from the financial assistance provided under the TARP remains outstanding for TARP participants with an obligation, or (ii) the last day of the TARP participant's fiscal year including the sunset date for a TARP participant that has never had an obligation.

[16] §111(b)(2) of EESA states that "[t]he Secretary shall require each TARP recipient to meet appropriate standards for executive compensation and corporate governance," and the lead-in to §111(b)(3) states that "[t[he standards established under paragraph (2) *shall include* the following:…" (emphasis added).

[17] §111(b)(4) of EESA.

[18] §111(b)(4)(A) of EESA.

[19] §111(b)(4)(B) of EESA.

[20] *See* the discussion of §111(e) of EESA, at note 53, *infra*.

[21] §111(b)(1)(A) and (h) of EESA; s*ee also* the letter dated February 20, 2009 from Senator Christopher J. Dodd (D-CT) to The Honorable Mary Schapiro, Chairman of the SEC.

[22] The June 2009 Interim Final Rule essentially implements §111 of EESA. The effective date of the rule was June 15, 2009, the date the guidance was published in the Federal Register. §30.17 Q-17 ("How do the effective date provisions apply with respect to the requirements under section 111 of EESA?").

[23] Some of these new standards are derived from the principles set forth in the February 2009 Treasury Guidance.

[24] For purposes of ARRA, a "TARP recipient" is defined as "any entity that has received or will receive financial assistance under the financial assistance provided under the TARP." §111(a)(3) of EESA. The definition is worded slightly differently in the June 2009 Interim Final Rule: a "TARP recipient" is defined as "any entity that has received or holds a commitment to receive financial assistance." §30.1 Q-1 (definition of *"TARP recipient"*).

number of reasons it is likely that they will influence any reform legislation that is enacted in the future, as well as the evolution of corporate governance and executive compensation "best practices." First, there is the public perception that the compensation practices addressed (and now regulated) by the standards are not limited to companies in the financial sector. Consequently, this thinking goes, the legislative response to those practices should be equally applicable to other companies. Second, several of the standards reflect remedial measures that have been advocated by shareholder groups for several years. Thus, their inclusion in EESA and ARRA is seen as simply the first step towards their broader application. Finally, the standards have made it through the legislative gauntlet; something that numerous previous reform efforts have failed to do. Accordingly, they are viewed as requirements that enjoy broad congressional (and, in some cases, administration) support, thereby easing their subsequent extension to the general corporate community.

With this in mind, here is a summary of the executive compensation standards of EESA and an assessment of their prospects for broader application. Essentially, the standards can be grouped into three broad categories: those that are likely to be converted into general requirements (either through the legislative or regulatory process or, possibly, as "best practices"); those that are not amenable to general application; and those whose status is problematic. While, at this time, the standards falling into this last category are not likely to be applied beyond TARP participants, given their subject matter, they easily could be incorporated into an active legislative or regulatory initiative if another corporate scandal were to erupt during the next few months.

NEW STANDARDS THAT ARE LIKELY TO BECOME GENERAL REQUIREMENTS

Several of the executive compensation standards that emerged from the federal response to the global economic crisis have sparked interest among the various constituencies seeking to address current pay practices. The following standards have already been identified as the basis for potential legislative and regulatory reforms, or may be the foundation for the development of "best practices" to be promoted by corporate governance advocates.

Prohibition on Excessive Risk

The executive compensation standards of EESA required that a TARP participant place limits on its compensation program to exclude incentives that encouraged its SEOs to take unnecessary and excessive risks that threatened the value of the participant.[25] ARRA did not change this standard.[26] In fact, it actually expands the scope of this requirement to encompass compensation arrangements for all of a TARP participant's employees, not just its SEOs.

To achieve this objective, ARRA requires each TARP participant to establish a board compensation committee[27] to review its employee compensation plans.[28] While virtually every public reporting company (and all companies with a class of securities listed on the New York Stock Exchange) already has a board compensation committee comprised of independent directors,[29] if a TARP participant does not have such a committee, it must establish and maintain a compensation committee in the period during which it is receiving financial assistance.[30] There has been little debate on the merits of establishing a committee of independent directors to oversee a company's executive pay practices.

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[25] §111(b)(3)(A) of EESA, before amendment by ARRA.

[26] §111(b)(3)(A) of EESA.

[27] For purposes of ARRA, a "compensation committee" is defined as "a committee of independent directors, whose independence is determined pursuant to Item 407(a) of Regulation S-K (17 CFR §229.407(a))." §30.1 Q-1 (definition of *"Compensation committee"*).

[28] §111(b)(3)(F) and (c)(1) of EESA. In the case of a TARP participant that is not a public company and that has received $25 million or less of TARP assistance, the duties of the board compensation committee may be carried out by the board of directors of the TARP participant. §111(c)(3) of EESA.

[29] New York Stock Exchange Euronext Listed Company Manual, §303A.05. While The Nasdaq Stock Market does not require the maintenance of a formal compensation committee of the board of directors, it does require that the functions of a compensation committee be performed by a committee consisting solely of independent directors or by a majority of the company's independent directors acting in executive session. Rule 5605(d).

[30] §30.4 Q-4(a) ("What actions are necessary for a TARP recipient to comply with the standards established under sections 111(b)(3)(A), 111(b)(3)(E), 111(b)(3)(F) and 111(c) of EESA (evaluation of employee plans and potential to encourage excessive risk or manipulation of earnings)?"). For these purposes, the "TARP period" is defined as "the period beginning with the TARP recipient's receipt of any financial assistance and ending on the last date upon which any obligation arising from financial assistance remains outstanding"; §30.1 Q-1 (definition of *"TARP period"*).

Among other things, for purposes of EESA and ARRA, this compensation committee must "discuss, evaluate, and review" at least every six months with the TARP participant's senior risk officers:

- its SEO compensation plans[31] to ensure that these plans do not encourage the SEOs to take unnecessary and excessive risks that threaten the value of the TARP participant;[32] and

- its employee compensation plans[33] in light of an assessment of any risk posed to the TARP participant from such plans.[34]

While the standard does not specify what constitutes an "excessive or unnecessary risk" for purposes of evaluating an SEO compensation plan, Treasury has provided guidance on how a board compensation committee is to conduct this semi-annual review. Specifically, the compensation committee must identify the features in the TARP participant's SEO compensation plans that could lead SEOs to take either short-term or long-term risks that could threaten the value of the TARP participant, including any features in the SEO compensation plans that would encourage behavior focused on short-term results and not on long-term value creation. The compensation committee is required to limit these features to ensure that the SEOs are not encouraged to take risks that are unnecessary or excessive.

Treasury also has provided guidance on how a board compensation committee is to conduct the mandated semi-annual review of employee compensation plans. Once again, the compensation committee must identify the features in the TARP participant's employee compensation plans that pose risks to the participant, including any features that would encourage behavior focused on short-term results and not on long-term value creation. The compensation committee is required to limit these features to ensure that the TARP recipient is not unnecessarily exposed to risks.

In addition, at least annually, the TARP participant must provide a narrative description of how its SEO and employee compensation plans do not encourage its SEOs or its employees to take unnecessary and excessive risks that threaten the value of the participant and how these compensation plans do not encourage behavior focused on short-term results rather than long-term value creation.[35] Finally, the board compensation committee must certify that it has completed the reviews of the SEO and employee compensation plans.[36] In the case of a TARP participant that is a public company, this certification is to be included in the compensation committee report as part of its executive compensation disclosure as required under the Exchange Act and to Treasury.[37] If the TARP participant is not a public company, the certification is to be provided to its primary regulatory agency and to Treasury.[38]

This risk-assessment requirement appears to have captured the imagination of regulators, even though it is directed towards the specific type of compensation arrangements used by financial institutions, that is, uncapped annual incentive compensation plans. For example, the staff of the SEC has indicated that, in

[31] "SEO compensation plan" is defined as "a 'plan' as that term is defined in Item 402(a)(6)(ii) of Regulation S-K (17 CFR §229.402(a)(6)(ii)), but only with regard to an SEO compensation plan in which an SEO participates"; §30.1 Q-1 (definition of *"SEO compensation plan"*). Item 402(a)(6)(ii) defines a "plan" to include, among other things, the following: "Any plan, contract, authorization, or arrangement, whether or not set forth in any formal document, pursuant to which cash, securities, similar instruments, or any other property may be received. A plan may be applicable to one person. Registrants may omit information regarding group life, health, hospitalization, or medical reimbursement plans that do not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that are available generally to all salaried employees."

[32] §30.4 Q-4(a)(1).

[33] An "employee compensation plan" is defined as "a 'plan' as that term is defined in Item 402(a)(6)(ii) of Regulation S-K (17 CFR §229.402(a)(6)(ii)), but only any employee compensation plan in which two or more employees participate and without regard to whether an executive officer participates in the employee compensation plan"; §30.1 Q-1 (definition of *"employee compensation plan"*); *see* note 31, *supra*.

[34] §111(c)(2) of EESA; §30.4 Q-4(a)(1).

[35] §30.4 Q-4(a)(4). The certification requirements that supplement this standard provide that the board compensation committee must provide a narrative description identifying each SEO and employee compensation plan and explaining how such plans do not encourage the SEOs and employees to take unnecessary and excessive risks that threaten the value of the TARP recipient. §30.7 Q-7(b) ("How does a TARP recipient comply with the certification and disclosure requirements under §30.4 (Q-4) of this part?").

[36] §30.4 Q-4(a)(5).

[37] Item 407(e) of Regulation S-K (17 CFR §229.407(3)); §30.7 Q-7(c).

[38] §30.7 Q-7(d).

preparing the compensation discussion and analysis, all companies, not just TARP participants, may need to address whether their incentive compensation arrangements could lead to excessive or unnecessary risk-taking.[39] More recently, the SEC has proposed a new disclosure item under which companies would be required to discuss in their Compensation Discussion and Analysis their compensation policies or practices as they relate to risk-management practices and risk-taking incentives, to the extent that these risks may have a material impact on their business.[40]

Consequently, it appears that, at a minimum, companies will have to address their risk-management programs as part of their required Exchange Act disclosure, including the relationship between their incentive compensation arrangements and risk profile. This is likely to involve more than simply certifying that a risk assessment has been conducted. It may well mean explaining to shareholders how a company's executive compensation program precludes excessive and unnecessary risk-taking.

More elaborate requirements are also possible. For example, the February 2009 Treasury Guidance contemplated that TARP participants receiving exceptional assistance submit their explanation that their executive compensation programs are tied to sound risk management to a non-binding shareholder vote.

Prohibition on Plans that Encourage Earnings Manipulation

The executive compensation standards of EESA prohibit TARP participants from maintaining any compensation plan that encourages manipulation of the participant's reported earnings to enhance the compensation of any of its employees.[41] Treasury's guidance on compliance with this standard closely parallels its guidance on the evaluation of SEO and employee compensation plans to minimize risk.

The board compensation committee of a TARP participant must "discuss, evaluate, and review" at least every six months the TARP participant's employee compensation plans to ensure that they do not encourage the manipulation of its reported earnings to enhance the compensation of any of its employees.[42] This review entails both the identification and elimination of any plan features that could encourage such behavior.[43] Further, at least annually, the TARP participant must provide a narrative description of how it has ensured that its employee compensation plans do not encourage the manipulation of reported earnings and certify that it has completed the required review and assessment.[44]

Because of its close relationship to the risk-assessment standard, it is entirely possible that this prohibition (or some variation thereof) may be considered the type of "reform" that should be applied more broadly. Some observers have suggested that this prohibition is actually just a specific formulation of the excessive risk standard previously described. If that's the case, then it may be more likely that it will be addressed as part of the provision encompassing that standard rather than as a separate requirement.

Compensation Recovery Policy

The executive compensation standards of EESA require TARP participants to adopt a policy requiring

[39] Remarks of John W. White, Director of the Division of Corporation Finance, at the 3rd Annual Proxy Disclosure Conference (October 21, 2008), *Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape in 2009*:

> [C]onsider the broader implications and ask yourself this question: Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target – with risk, in this case, being viewed in the context of the enterprise as a whole? I'll let you think about what Congress might want. We know what our rules require. That is, to the extent that such considerations are or become a material part of a company's compensation policies or decisions, a company would be required to discuss them as part of its CD&A.

[40] Securities Act Release No. 9052, *Proxy Disclosure and Solicitation Enhancements* (July 10, 2009) (the "SEC Proposing Release").

[41] §111(b)(3)(E) of EESA.

[42] §30.4 Q-4(a)(3).

[43] §30.6 Q-6 ("How does a TARP recipient comply with the requirement under §30.4 (Q-4) of this part that the compensation committee discuss, evaluate, and review the employee compensation plans to ensure that these plans do not encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of any of the TARP recipient's employees?").

[44] §30.4 Q-4(a)(4); §30.7 Q-7(b); §30.4 Q-4(a)(5); §30.7 Q-7(a).

recovery of any bonus,[45] retention award,[46] or incentive compensation[47] paid to an SEO or any of their next 20 most highly compensated employees where the compensation has been paid based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.[48] As explained in the June 2009 Interim Final Rule, this policy is to cover payments based on materially inaccurate financial statements (which includes, but is not limited to, statements of earnings, revenues, or gains) or any other materially inaccurate performance metric criteria.[49]

Whether a financial statement or performance metric criteria is materially inaccurate will depend on all of the relevant facts and circumstances. However, for purposes of this standard, a financial statement or performance criterion is to be treated as materially inaccurate with respect to any employee who knowingly engaged in providing inaccurate information (including knowingly failing to timely correct inaccurate information) relating to those financial statements or performance metrics.[50] In other situations, however, whether the inaccurate measurement or application to a performance criterion is material will depend on whether the actual performance is materially different from the performance required under the criterion.[51] A TARP recipient is required to exercise its "clawback" rights except where it demonstrates that it would be unreasonable to do so (such as, for example, if the expense of enforcing the rights would exceed the amount recovered).

While, in many respects, this requirement parallels the move towards compensation recovery policies that began following the enactment of the Sarbanes-Oxley Act of 2002,[52] it goes farther than most existing "clawback" policies in two respects. First, it covers a larger group of executives. Second, it potentially covers inaccurate information relating to the performance metrics used to calculate incentive compensation. Most existing compensation recovery policies only apply to a company's chief executive officer and chief financial officer and then only to the extent that the inaccuracy results in a financial restatement.

It appears likely that any reform initiative will include a broad compensation recovery provision that will apply, at a minimum, to a company's senior executive officers. Given the favorable reception that these provisions have already received from companies and investors alike, as well as the indisputable reality that companies should have the ability to recover compensation that has been paid erroneously, it is difficult to argue against such a requirement. In addition, such policies are viewed as an effective risk-mitigation tool. Therefore, they are becoming an integral part of a sound risk-management program.

Advisory Vote on Executive Compensation

The executive compensation standards of EESA require that a TARP participant conduct an annual advisory vote on executive compensation (a so-called "Say on Pay" vote) at its annual meeting of shareholders.[53] ARRA expressly and emphatically

[45] The term "bonus" is generally defined as "any payment in addition to any amount payable to an employee for services performed by the employee at a regular hourly, daily, weekly, monthly, or similar periodic rate." §30.1 Q-1 (definition of *"Bonus"*).

[46] The term "retention award" is generally defined as "any payment to an employee, other than a payment of commission compensation, a payment made pursuant to a pension or retirement plan which is qualified (or is intended within a reasonable period of time to be qualified) under section 401 of the Internal Revenue Code (26 U.S.C. 401), a payment made pursuant to a benefit plan, or a payment of a fringe benefit, overtime pay, or reasonable expense reimbursement that: (i) is not payable periodically to an employee for services performed by the employee at a regular hourly, daily, weekly, monthly, or similar periodic rate (or would not be payable in such manner absent an elective deferral election); (ii) is contingent on the completion of a period of future service with the TARP recipient or the completion of a specific project or other activity of the TARP recipient; and (iii) is not based on the performance of the employee (other than a requirement that the employee not be separated from employment for cause) or the business activities or value of the TARP recipient." §30.1 Q-1 (definition of *"Retention award"*).

[47] The term "incentive compensation" is generally defined as "compensation provided under an incentive plan." §30.1 Q-1 (definition of *"Incentive compensation"*).

[48] §111(b)(3)(B) of EESA. For purposes of this standard, a bonus payment is deemed to be made to an individual when the individual obtains a legally binding right to that payment. §30.8 Q-8 ("What actions are necessary for a TARP recipient to comply with the standards established under section 111(b)(3)(B) of EESA (the "clawback" provision requirement)?").

[49] §30.8 Q-8.

[50] *Id.*

[51] *Id.*

[52] Public Law 107-204 (July 30, 2002) §304.

[53] §111(e)(1) of EESA; §30.13 Q-13 ("What actions are necessary for a TARP recipient to comply with section 111(e) of EESA

underscores that this vote is to be "non-binding' on the TARP participant's board of directors and will not override any board decisions.[54] For these purposes, the executive compensation to be voted on by the shareholders is to be based on the information about executive compensation required to be disclosed in a TARP participant's annual report on Form 10-K and definitive proxy statement (which disclosure includes the compensation discussion and analysis, the compensation tables, and any related material).[55]

With a nudge from Senator Christopher Dodd (D-CT),[56] the SEC determined that this provision was to be applicable during the 2009 proxy season. Consequently, nearly 300 financial institutions included proposals providing for an advisory vote on the institution's executive compensation program in their 2009 proxy statements.

In the four years since the first "Say on Pay" proposal was submitted to U.S. companies, the movement has generated levels of support unseen by most other compensation-oriented shareholder proposals. Consequently, it should come as no surprise that the prospect for an annual advisory vote requirement for all companies is extremely high. In fact, on July 31, 2009, the House of Representatives approved a bill that would require public companies to give their shareholders an annual advisory vote on their executive compensation programs.[57] With the Obama administration, Congress, and regulators supporting the advisory vote concept, it is simply a matter of time before an annual advisory vote mandate becomes law.

Compensation Consultant Engagement Disclosure

Pursuant to the authority conferred on it by EESA,[58] Treasury has established an additional executive compensation standard concerning a TARP participant's engagement of a compensation consultant to assist the participant, the board of directors, or the board compensation committee.[59] Under this standard, each year the board compensation committee of the TARP participant[60] must disclose whether the TARP participant, its board of directors, or the board compensation committee has engaged a compensation consultant, and describe all types of services (including non-compensation-related services) the consultant or any of its affiliates has provided to the TARP recipient, the board of directors, or the compensation committee during the past three years. This description must include any "benchmarking" or comparisons used to identify certain percentile levels of compensation (that is, the companies used for benchmarking purposes and a justification for using these companies and the lowest percentile level proposed for compensation (for example, whether compensation is benchmarked to the 50% or 75% percentile of the companies in the comparator group)). This disclosure is to be provided within 120 days after the end of each fiscal year to the TARP participant's primary regulator and to Treasury.[61]

This is another area where the SEC is likely to enhance its present disclosure requirements about the use of compensation consultants.[62] Recently, the SEC proposed new requirements for additional disclosure about compensation consultants (or their affiliates) that are involved in assisting companies, or their boards of

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(the shareholder resolution on executive compensation requirement)?"). In addition, the SEC must issue any final rules and regulations required by the standard within one year of the date of enactment of ARRA. §111(e)(3) of EESA. On July 1, 2009, the SEC voted to issue proposed rules setting forth the requirements for U.S. companies subject to §111(e) of EESA. Exchange Act Release No. 60218, *Shareholder Approval of Executive Compensation of TARP Recipients* (July 1, 2009).

[54] §111(e)(2) of EESA. This provision goes on to also state that the vote does not create or imply any additional fiduciary duty by the TARP participant's board of directors, nor shall it be construed to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.

[55] §111(e)(1) of EESA.

[56] Letter from Senator Christopher J. Dodd to the Honorable Mary Schapiro, Chairman of the SEC, dated February 20, 2009.

[57] H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009. The bill also would require a separate advisory shareholder vote on any golden

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parachute arrangements relating to a merger or other corporate transaction that had not previously been subject to the annual advisory vote on compensation programs.

[58] §111(h) and §111(b)(2) of EESA.

[59] §30.11 Q-11(c) ("Are TARP recipients required to meet any other standards under the executive compensation and corporate governance standards in section 111 of EESA?").

[60] If a TARP participant is not required to maintain a board compensation committee, this disclosure is to be provided by the board of directors. §30.11 Q-11(c)(2).

[61] §30.11 Q-11(c)(1) and (3).

[62] Item 407(e)(3) of Regulation S-K (17 CFR §229.407(e)(3)).

directors, in determining or recommending executive or director compensation. As proposed, where a compensation consultant (or any of its affiliates) played a role in determining or recommending executive and director compensation and also provided additional services to the company, then the company would be required to disclose (i) the nature and the extent of all additional services provided; (ii) the aggregate fees paid to the consultant for its executive or director compensation; and (iii) the aggregate fees paid to the consultant for the additional (non-compensation-related) services.[63] Consequently, companies should expect that they will have to provide more information about their use of compensation consultants next year.

NEW STANDARDS THAT ARE NOT LIKELY TO BECOME GENERAL REQUIREMENTS

While a few of the executive compensation standards do not appear to be candidates for broad-based legislative or regulatory reforms, they address subjects of common concern within the investor community. Consequently, although it is unlikely that these limitations or prohibitions will be extended beyond TARP, they have spotlighted these practices and are clearly candidates for "best practices" to be promoted by corporate governance advocates.

Bonus Limitation

Under the executive compensation standards of EESA, a TARP participant is prohibited from paying or accruing any bonus, retention award, or incentive compensation for certain specified employees.[64] The one exception to this restriction is that a TARP participant may award bonuses in the form of long-term restricted stock that "does not fully vest" during the TARP period and is valued at no more than one-third of the employee's "total amount of annual compensation."[65] The identity and number of employees subject to this restriction varies depending on the level of financial assistance that the TARP participant has received.[66]

It is unlikely that a "substantive" compensation standard, such as this bonus limitation, will be part of any reform initiative. While such standards can be justified in situations, such as the TARP, where a provider of capital is extracting concessions in exchange for its investment,[67] these provisions go well beyond the traditional conventions for regulating the markets. Consequently, absent catastrophic and, as yet, unforeseen circumstances, its not expected that Washington will seek to impose substantive restrictions

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[63] SEC Proposing Release.

[64] §111(b)(3)(D)(i) of EESA; §30.10 Q-10 ("What actions are necessary for a TARP recipient to comply with section 111(b)(3)(D) of EESA (the limitation on bonus payments)?"). This prohibition applies to financial institutions that became TARP participants prior to the enactment of ARRA as well as those that become TARP participants in the future. §111(a)(3) of EESA. However, the provision does not prohibit any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009, provided the Secretary of the Treasury finds that the contract is valid. §111(b)(3)(D)(iii) of EESA; §30.10 Q-10(e)(2).

[65] §111(b)(3)(D)(i)(I) and (II) of EESA; §30.10 Q-10(e)(1). The Secretary of the Treasury is authorized to place other terms and conditions on the restricted stock as he determines to be in the public interest. §111(b)(3)(D)(i)(III) of EESA.

[66] If the financial assistance is less than $25 million, the restriction applies only to the TARP participant's most highly compensated employee; if at least $25 million but less than $250 million, to the TARP participant's five most highly compensated employees; if at least $250 million but less than $500 million, to the TARP participant's SEOs and at least its 10 next most highly compensated employees; if at least $500 million, to the TARP participant's SEOs and at least its 20 next most highly compensated employees. §111(b)(3)(D)(ii)(I)-(IV) of EESA; §30.10 Q-10(b). Where the TARP participant has received at least $25 million in financial assistance, the Secretary of the Treasury may apply the restriction to a higher number of employees if he determines this is in the public interest. For these purposes, a "most highly compensated employee" is defined generally as "the employee of a TARP recipient, other than the SEOs of the TARP recipient, whose annual compensation is determined to be the highest among all employees of the TARP recipient." §30.1 Q-1 (definition of *"Most highly compensated employee"*).

[67] *E.g.*, S. 360, the "Cap Executive Officer Pay Act of 2009," introduced in the Senate by Senator Claire McCaskill (D-MO) on January 30, 2009. This bill proposes to cap the annual compensation of any person serving as an officer, director, executive, or other employee of a TARP participant at a level no greater than the amount of compensation paid to the President of the United States; the February 2009 Treasury Guidance contained a $500,000 cap on the annual compensation paid to a TARP participant's senior executives (subject to a limited exception for payments made in the form of restricted stock or similar long-term incentive arrangements).

on the amounts that companies can pay their executives.[68]

Prohibition on "Golden Parachute Payments"

The executive compensation standards of EESA prohibit TARP participants from making any "golden parachute payments" to their SEOs and their next five most highly compensated employees during the TARP period.[69] The term "golden parachute payment" means any payment to an SEO with respect to the departure from a company for any reason, except for payments for services performed or benefits accrued.[70] For these purposes, a golden parachute payment is treated as paid at the time of departure and is equal to the aggregate present value of all payments made for a departure.[71]

Even though criticism of executive severance arrangements is at an all-time high, it appears unlikely that any reform initiative will contain an absolute prohibition on such payments. However, should public pressure continue to escalate, it is possible that Congress may feel compelled to attempt to limit the amount or form of such arrangements. EESA contains a provision that extends the non-deductibility/excise tax rules of Sections 280G and 4999 of the Internal Revenue Code to certain compensatory payments made in connection with involuntary terminations of employment or in connection with a bankruptcy filing, insolvency, or receivership of a TARP participant.[72] It is entirely possible that Congress may choose to apply some variation of this provision to severance arrangements that exceed certain dollar thresholds. Alternatively, the SEC could require public companies to provide an explanation if the severance arrangements of their senior executives exceed a specified amount (for example, more than twice an executive's annual base salary and bonus).

Prohibition on Tax "Gross-Ups"

Pursuant to the authority conferred by EESA,[73] Treasury has established an additional executive compensation standard prohibiting a TARP participant from providing (either formally or informally) gross-ups to any of its SEOs and the next 20 most highly compensated employees during the TARP period.[74] For purposes of this prohibition, providing a gross-up includes providing a right to a payment of a gross-up at a future date, such as a date after the TARP period.[75] The June 2009 Interim Final Rule generally defines a "gross-up" as "any reimbursement of taxes owed with respect to any compensation."[76]

While tax gross-ups have become anathema to investors in recent years, it is doubtful that this item will be the subject of a flat prohibition. Although limited, there may be circumstances where a board compensation committee determines that it is reasonable and in the best interests of the company to provide an executive or other employee with reimbursement of the taxes that arise in connection with a compensatory arrangement. Accordingly, it is much more likely that, similar to perquisites and other personal benefits, tax reimbursements and other tax payments (including "gross-up" provisions) may be subject to enhanced disclosure to provide shareholders with better information about the existence and basis for such arrangements.

NEW STANDARDS WITH IMPACTS STILL TO BE DETERMINED

Some of the executive compensation standards, including one of the standards introduced by the June

[68] However, it should be noted that H.R. 3269 would confer upon regulators the authority to prohibit certain compensation arrangements at financial institutions with assets in excess of $1 billion if these arrangements could "threaten the safety and soundness" of the institution or have "serious adverse effects on economic conditions or financial stability."

[69] §111(b)(3)(C) of EESA; §30.9 Q-9 ("What actions are necessary for a TARP recipient to comply with the standards established under section 111(b)(3)(C) of EESA (the prohibition on golden parachute payments)?").

[70] §111(a)(2) of EESA. §30.1 Q-1 (definition of *"Golden parachute payment"*). This definition was significantly changed by ARRA. As originally enacted in EESA, a "golden parachute payment" was defined to mean any severance payment to the extent that the aggregate present value of the payment equals or exceeds three times an SEO's "base amount" (as defined under Section 280G(b)(3) of the Internal Revenue Code). §30.9 of the Interim Final Rule, 31 CFR Part 30. Public criticism of the original provision was largely responsible for its revision.

[71] §30.9 Q-9(a). Thus, a golden parachute payment during a TARP period may include a right to amounts actually payable after the TARP period.

[72] §302(b) of EESA.

[73] §111(h) and §111(b)(2) of EESA.

[74] §30.11 Q-11(d).

[75] *Id.*

[76] §30.1 Q-1 (definition of *"Gross-up"*). Generally, a "gross-up" does not include a payment under a tax equalization agreement.

2009 Interim Final Rule, address topics that either have yet to be identified as raising corporate governance or executive compensation concerns or are already subject to regulation. Consequently, the impact of these standards on future legislative or regulatory initiatives or "best practices" developments is problematic.

Luxury Expenditures Policy

In response to several widely publicized corporate excesses, ARRA added to the executive compensation standards of EESA a provision addressing the use of corporate funds for certain "excessive" or "luxury" expenses. The standards provide that the board of directors of any TARP participant must institute a company-wide policy regarding excessive or luxury expenditures, which may include excessive expenditures on entertainment or events, office and facility renovations, aviation or other transportation services, and other activities or events that are not reasonable expenditures for:

- staff development;
- reasonable performance incentives; or
- other similar measures conducted in the normal course of the TARP participant's business operations.[77]

Within 90 days after the closing date of an agreement between the TARP participant and Treasury, or June 15, 2009, the board of directors of the TARP participant must adopt an excessive or luxury expenditures policy, provide this policy to Treasury and its primary regulatory agency, and post the text of this policy on its Internet website (if the TARP participant maintains a corporate website).[78] Once adopted, the TARP participant must maintain the policy during the remaining TARP period (if the TARP participant has an obligation), or through the last day of the TARP recipient's fiscal year that includes December 31, 2009 – the date on which the authorities provided under EESA generally expire (if the TARP participant has never had an obligation).[79]

While the objectives of this standard are comparable to the compensation limits imposed by EESA and ARRA, it is problematic whether the concept will be part of any reform initiative. On the one hand, there are few policy reasons for requiring companies to limit the size and scope of expenditures that ostensibly serve a legitimate business purpose. On the other hand, the growing public perception that many of these expenditures are indistinguishable from perquisites or other personal benefits – a category of expenses that have long come in for significant criticism – may be sufficient to persuade legislators that some external controls are warranted. Ultimately, the presence or absence of this type of restriction in a reform initiative may depend on whether a specific scandal involving these types of expenditures is unfolding at the time the legislation is being considered.

Perquisites Disclosure

Pursuant to the authority conferred by EESA,[80] Treasury has established an additional executive compensation standard that requires a TARP participant to annually disclose during the TARP period any perquisite whose total value for the TARP recipient's fiscal year exceeds $25,000 for each of the SEOs and most highly compensated employees who are subject to the bonus limitation of the standards.[81] Specifically, within 120 days after the end of each fiscal year any part of which is a TARP period, a TARP participant must provide a narrative description of the amount and nature of each perquisite, the recipient or recipients of the perquisite, and a justification for offering it.[82] This disclosure is to be provided to the TARP participant's primary regulatory agency and to Treasury.[83]

Public companies are already required to provide extensive disclosure about their executive perquisites practices under the SEC's executive compensation disclosure rules.[84] Thus, to the extent that this standard covers SEOs, it merely duplicates an existing disclosure rule. The required disclosure concerning other highly compensated employees is consistent with ARRA's approach to greater transparency for excessive or luxury expenditures, and appears aimed at ensuring

[77] §111(d) of EESA.

[78] §30-12 Q-12 ("What actions are necessary for a TARP recipient to comply with section 111(d) of EESA (the excessive or luxury expenditures policy requirement)?").

[79] *Id.*

[80] §111(h) and §111(b)(2) of EESA.

[81] §30.11 Q-11(b)(1).

[82] *Id.* This justification pertains to the offering of the perquisite, and not just for offering the perquisite with a value that exceeds $25,000.

[83] §30.11 Q-11(b)(2).

[84] Item 402(c)(2)(ix)(A) of Regulation S-K (17 CFR §229.402(c)(2)(ix)(A)).

transparency as to how a TARP participant is using its funds, including the assistance it has received from the federal government. Consequently, it is unlikely that there will be any momentum for extending this standard beyond the TARP program.

Tax Deductibility of Executive Compensation

The executive compensation standards, as enacted by EESA prior to ARRA,[85] included a tax deduction limitation based on the provisions of Section 162(m) of the Internal Revenue Code. This provision effectively reduced the $1 million deduction limit of Section 162(m) to $500,000 for compensation paid to certain executives of TARP participants and provided that certain exceptions to the deduction limit, including the exception for "performance-based compensation," do not apply for purposes of applying the reduced cap. This standard has been incorporated into the ARRA.[86] The June 2009 Interim Final Rule does not impose any additional tax-related restrictions beyond those already applicable under Section 162(m)(5). In addition, because this restriction is not inconsistent with the June 2009 Interim Final Rule, it remains in effect and TARP participants continue to be required to forgo any applicable deduction.[87]

Since the original Section 162(m) deduction limit has not proven to be effective in influencing the amount of compensation paid to corporate executives, it is problematic as to whether the Obama Administration or Congress will seek to extend the Section 162(m)(5) restriction more broadly. In all likelihood, given the perception that it has been largely ineffectual, it will not be high on the list of potential reforms. However, given Congress' long-standing interest in reforming Section 162(m), its revision cannot be wholly dismissed. While, in some instances, the loss of the federal income tax deduction may generate pressure on specific companies to revise their pay practices, the lack of transparency as to when senior executive compensation is not fully deductible and the actual financial impact on the company make it difficult to bring shareholder attention to this issue. To alleviate this problem, it will be necessary for the SEC to amend its disclosure rules to require companies to provide this specific information in connection with the discussion of the tax implications of an executive compensation program.

CONCLUSION

Although the new executive compensation standards represent a stinging criticism of the pay practices of many of the financial institutions that required government funds to maintain solvency, they are not necessarily an appropriate template for reforming the current executive compensation field. Nonetheless, given the current environment – both political, as well as economic – they are likely to have a significant influence on any new regulatory framework and the evolution of best practices. It remains to be seen whether their potential effect will be tempered by the recognition that the conditions giving rise to their adoption are not present in most companies and that too much regulation could unduly hamper companies' ability to develop appropriate compensation programs in what has turned into a truly challenging environment. ■

[85] §302(a) of EESA added new §162(m)(5) to the Internal Revenue Code. This limitation was then applied to TARP participants by §111(b)(1) of EESA. Further, the October 2008 Interim Final Rule required that TARP participants forgo any federal income tax deduction for compensation that would not be deductible if §162(m)(5) were to apply to such participant. As a result, TARP participants were required to agree in their financial arrangements with Treasury under TARP not to claim a tax deduction for compensation in excess of $500,000 paid to an SEO during a taxable year.

[86] §111(b)(1)(B) of EESA.

[87] In addition, Treasury expects to impose this restriction on any companies receiving financial assistance under TARP in the future.

CLE QUESTIONS on Borges, *The TARP Executive Compensation Standards – A Sign of Things to Come?* (September 9, 2009). Please circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by fax to RSCR-CLE, 212-876-3441, or by e-mail attachment to rscrpub@att.net.

1. The Emergency Economic Stabilization Act of 2008 required financial institutions participating in the TARP to comply with executive compensation standards for their top eight most highly paid executives. **True** **False**

2. The February 2009 Treasury Guidance did not require financial institutions receiving assistance through a generally available capital access program to adopt a company-wide policy limiting expenditures on entertainment, parties, and conferences. **True** **False**

3. The American Recovery and Reinvestment Act of 2009 requires that a TARP participant's chief executive officer annually certify that the company has complied with the new standards for executive compensation. **True** **False**

4. The new standards generally require a "clawback" of compensation based on materially inaccurate information, but only if the inaccuracy results in a financial restatement
True **False**

5. Treasury has established an executive compensation standard prohibiting a TARP participant from providing "gross-ups" – *i.e.* reimbursement for taxes owed – to certain highly compensated employees during the TARP period. **True** **False**

A F F I R M A T I O N

____________________________, Esq., an attorney at law, affirms pursuant to CPLR
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2106 and under penalty of perjury that I have read the above article and have answered the above questions without the assistance of any person.

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