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NEW ROUND OF EXECUTIVE COMPENSATION RESTRICTIONS FOR BANKS

by Ellen R. Marshall and John J. Heber

The Treasury Department has announced that it will be issuing new guidelines on executive compensation for financial institutions. Here is a brief summary of what the new rules are expected to[1] do that is different from the executive compensation restrictions that were imposed in October 2008, as part of the implementation of the Emergency Economic Stabilization Act of 2008 (EESA) and the original Capital Purchase Program (CPP). (See our summary of those rules dated October 17, 2008.)

What's Changing?

The new guidelines distinguish between banks participating in any generally available capital access program under the EESA (such as the original CPP) and banks needing "exceptional financial recovery assistance" (EFRA). The Treasury Department has developed additional executive compensation guidelines for institutions that receive EFRA, i.e., those that receive special customized treatment, rather than simply participating in a program that is announced by the Treasury and is available to a wide swath of qualifying companies on uniform terms. The EFRA recipients seem to be those, like AIG and Citi, that are given negotiated arrangements special to them.

It seems that the Treasury Department considers itself able to include these new restrictions within the negotiated terms of EFRA deals, without putting the new rules out for public comment. By comparison, new executive compensation rules that are intended for application "automatically," as part of the general EESA

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assistance that will have standardized terms and documentation, are being made the subject of a public comment period.

For financial institutions that receive federal assistance under the EESA in the future, the new guidelines, although somewhat looser than those imposed on the EFRA institutions, impose rules that are more restrictive than those previously in effect on the amount and type of compensation that will be permitted and which officers of the company are subject to those rules.

For All Recipients of Assistance under EESA

These are the changes that will apply to all future EESA assistance, subject to the comment period. These requirements also apply immediately to EFRA recipients, and as to those are not subject to the comment period:

- **Compensation Limit** – The total compensation paid to any of the 5 senior executives may not exceed $500,000, except for restricted stock awards. This limit replaces what had been a limit on tax deductibility at that level in the October 2008 rules. For companies that are not receiving EFRA, however, this cap may be waived as long as the compensation is fully disclosed and submitted to a non binding shareholder vote.
- **Disclosures** – The financial institution must review and disclose the reasons that the compensation arrangements for employees do not encourage excessive and unnecessary risk-taking. Under the October 2008 rules, this sort of review and analysis was required only for the top 5 executives and was to be certified to the Treasury Department. Now it applies to all employees (both senior executives and rank and file), and must be disclosed (though exactly to whom is not yet clear).
- **Clawback** – The October 2008 rules required a policy to recover compensation that is paid based on either a material misstatement in the financial statements or an error in calculating the measure to which incentive compensation is pegged. This will be expanded from applying to the 5 senior officers to applying to the top 25 senior officers.
- **Golden Parachutes** – The October 2008 rules prohibited the 5 senior officers from receiving parachute payments, as defined in Section 280G of the Internal Revenue Code, a definition that uses the measure of 3 times the “base amount” of

the individual's compensation. The new rule will change this to one year's compensation. This will, however, remain applicable only to the 5 senior officers, not a larger group. The prohibition continues to apply only to payments that would be made in the event of an involuntary termination of employment of the individual, or to a bankruptcy, insolvency, or receivership of the company.

- **Luxury Expenditures** – The Board of Directors must adopt a company wide policy on expenditures relating to aviation services, office and facility renovations, entertainment and holiday parties, and conferences and events. The policy need not cover reasonable expenditures for sales conferences, staff development, reasonable performance incentives, and other normal business operations. The policy must require a certification by the CEO for expenditures that "could be viewed as excessive or luxury items." The policy must be posted on the company's website.

For the Most Needy Recipients

In addition, for those financial institutions that receive the customized, negotiated EFRA, these changes will also apply:

- **Compensation Limit** – As noted above, the $500,000 compensation limit cannot be waived for EFRA recipients.
- **Restricted Stock Awards** – For any restricted stock awards beyond the $500,000 compensation limit, the vesting on the award must be delayed until the government has been repaid.
- **Shareholder Vote** – The senior executive compensation structure, and the rationale for how the compensation relates to sound risk management, must be submitted to a non binding shareholder vote.

Long-Term Reforms

The Treasury Department's announcement also describes a plan to study how compensation systems may have contributed to financial market problems, and to use the insights gained to assist companies and regulators to develop future compensation models. Ideas for this exercise include focus on:

- Alignment of compensation with sound risk

management
- Encouragement of long-term perspectives
- Shareholder involvement through non binding resolutions
- Colloquy among shareholder advocates, institutional investors, policy makers, executives, academics, and others

[1] This summary is based on the announcement issued by the United States Department of Treasury on February 4, 2009, prior to the issuance of formal implementing rules. Accordingly, this summary is fairly general, and is subject to amplification and clarification based upon the anticipated implementing rules, regulations, and guidelines.

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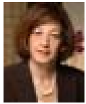

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