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Treasury Department Announces New Restrictions on Executive Compensation

Introduction

The Obama Administration, in one of its first actions involving the financial services industry crisis, imposed new executive compensation restrictions on financial institutions. The action was highly nuanced and reflects the difficult choices facing the government as it moves forward in its role as significant investor and/or guarantor in many of the nation's leading financial institutions.

The $500,000 cap on executive compensation and the imposition of limitations on luxury expenses respond to widespread public concern about the operations of financial institutions that have received financial assistance from the federal government. Nevertheless, it appears that the newly announced restrictions are largely not retroactive.

The Administration appreciates that placing arbitrary and strict restrictions on executive compensation at financial institutions that are already facing daunting challenges will simply make their recovery that much more challenging. However, the overall signal to financial institutions grows ever clearer – those institutions that participate in federal assistance programs will be viewed as appropriate subjects of significant federal control on executive compensation.

February 4, 2009, Announcement

On February 4, 2009, the Department of the Treasury ("Treasury") issued a press release announcing a new set of guidelines on executive compensation for certain financial institutions that receive government assistance. The guidelines distinguish between:

- Financial institutions participating in any new "generally available capital access program" and
- Financial institutions that need "exceptional assistance."

"Generally available capital access programs" are those programs that provide the same terms for all recipients, contain limits on the amount each institution may receive, and specify returns for taxpayers, such as the previously announced Capital Purchase Program ("CPP"). The new standards for generally available capital access programs **do not apply retroactively to previously announced programs**, such as the CPP and the Term Asset-Backed Securities Loan Facility. The Treasury intends to promulgate proposed guidance subject to public comment on the executive compensation provisions relating to generally available programs. "Exceptional assistance" occurs when an institution needs more assistance than is allowed under a widely available standard program and has bank-specific negotiated agreements with the Treasury. The guidelines address new executive compensation restrictions, compliance and certification requirements and potential long-term regulatory reform.

New Executive Compensation Restrictions for Companies Receiving Exceptional Financial Recovery Assistance

- Limitation on Annual Compensation

Currently, institutions participating in programs providing exceptional assistance may not take tax deductions for senior executive officer compensation above $500,000. The new guidelines expand this restriction by limiting the total amount of compensation (apart from non-restricted stock compensation) to $500,000 for senior executives of institutions receiving exceptional assistance. Any compensation to senior executives beyond $500,000 must be in the form of restricted stock or other long-term incentives that vest upon the government being repaid with interest or after a specified period in which certain conditions have been met, such as satisfying repayment obligations or meeting lending and stability standards.

- Shareholder Advisory Vote

The new guidelines require that the structure of senior executive remuneration and the rationales used to tie sound risk management to compensation be submitted to a non-binding shareholder resolution, known as a "say on pay" resolution.

- Clawbacks

Under existing programs providing exceptional assistance, the top five senior executive officers are subject to a clawback for any incentive or bonus payment if the payment was based on materially inaccurate financial statements or other materially inaccurate financial performance metric criteria. Under the new guidelines, this requirement is expanded and institutions must put in place provisions to claw back bonuses and incentive compensation from the top 25 senior executives if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive compensation.

- Golden Parachutes

The top ten executive officers of institutions receiving exceptional assistance are prohibited from any golden parachute payment upon severance from employment. Additionally, at least the next 25 executive officers are barred from receiving any golden parachute payment greater than one year's compensation. In contrast, existing programs that provide exceptional assistance prohibit only the top five senior executives from receiving golden parachute payments.

- Luxury Expenditures

The Board of Directors must adopt a company-wide policy on expenditures and perquisites relating to the approval of aviation services, office and facility renovation, entertainment and holiday parties, and conferences and events. According to the Treasury, this policy requirement is not intended to address reasonable expenditures relating to an institution's normal business operations, such as staff development, reasonable performance incentives and sales conferences. Under current circumstances, there may be a wide range of views as to what types of expenditures qualify as "reasonable." Institutions must also publish the text of adopted expenditure policies on their web sites.

New Executive Compensation Restrictions for Companies Participating in Generally Available Capital Access Programs

- Limitation on Annual Compensation

Institutions participating in generally available programs are subject to the same $500,000 and restricted stock limitations on senior executive compensation as institutions receiving exceptional assistance, except they have the ability to waive these requirements if they meet certain criteria. If an institution discloses their senior executive compensation and, if requested, submits a non-binding "say on pay" resolution for shareholder action, it will not be required to abide by the $500,000 compensation limitation. Furthermore, all institutions participating in a future generally available program must review and disclose the reasons that the compensation arrangements of senior executives, as well as all other employees, do not encourage excessive and unnecessary risk-taking. Under the CPP, this review and certification requirement only applied to the top five senior executive officers.

- Golden Parachutes

The top five senior executives, upon severance from employment, are prohibited from receiving a golden parachute payment greater than one year's compensation, as opposed to three years under the CPP.

- Clawbacks and Luxury Expenditures

The clawback and luxury expenditures provisions for institutions participating in generally available programs have the same requirements as the equivalent provisions for institutions that receive exceptional assistance.

Compliance and Certification

All institutions receiving government assistance must ensure compliance with executive compensation restrictions. The chief executive officer of all institutions that receive assistance or have received assistance in the past, such as participants in the CPP, must provide certification that the institution has complied with all executive compensation restrictions and re-certify compliance annually. Additionally, compensation committees must provide an explanation of how senior executive compensation arrangements do not encourage excessive and unnecessary risk-taking.

Long-Term Regulatory Reform

The Treasury announcement also briefly outlines potential future initiatives aimed at aligning compensation strategies with proper risk management and long-term value and growth. These efforts, intended to apply to company-wide compensation strategies at financial institutions, include the following:

- Requiring all compensation committees of all public financial institutions, not just those receiving government aid, to review and disclose their strategies for ensuring compensation aligns with sound risk-management and promotes long-term value for their companies and their shareholders.

- Including incentives in compensation arrangements for top executives that encourage a long-term perspective, such as requiring executives at financial institutions to hold stock for several years before it can be cashed-out.

- Using "say on pay" shareholder resolutions at financial institutions that allow shareholders to have a non-binding advisory vote on the level of executive compensation, as well as how the compensation incentives promote risk management and long-term value creation.

- Having the Secretary of the Treasury host a conference on long-term executive pay reform with a wide variety of interests, such as major public pension and institutional investors, shareholder advocates, executives and academics.

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