Treasury Implements TARP Compensation and Corporate Governance Standards

**Pros:** Greater Certainty of Programs Covered, Added Flexibility on Continuing Equity Compensation, Positive Clarification for Acquisitions and Guidance on Historic Actions

**Cons:** Restrictions on Non-Executives, Exempted Commissions Frozen, Restrictive Set of Governance Practices and Potential for Continuing Limits

**SUMMARY**

The U.S. Treasury Department yesterday issued long-awaited guidance on the compensation and corporate governance standards that will apply to TARP recipients, including the special rules for institutions that have received “exceptional assistance.” The balance struck sheds light on both Treasury’s desire to avoid discouraging participation in TARP programs and its belief that financial institution compensation practices require significant reform. Treasury also appointed Kenneth Feinberg as Special Master for TARP Executive Compensation, with broad authority to interpret Treasury’s guidance, set pay at exceptional assistance institutions and review pre-February 17, 2009 compensation at all TARP recipients.

TARP recipients will be subject to compensation restrictions on both executives and highly paid non-executives and almost certainly will need to rebalance their pay programs to modify both salary and bonus components. The guidance includes useful flexibility for continuing equity compensation as part of salary, which will help TARP recipients structure more efficient compensation in light of these constraints. New and restrictive governance practices and limits on commissions, however, could raise serious operational issues. The guidance also does not include additional detail on the process for repurchasing TARP-related warrants held by Treasury.
Treasury’s guidance takes the form of an interim final rule that becomes effective on publication in the Federal Register, currently scheduled for June 15, 2009. Treasury requests comments within 60 days of publication, and we expect to submit a comment letter.

MAJOR CONSIDERATIONS

The discussion that follows highlights some of the major considerations raised by the Treasury rule.

Guidance on historic actions. As contemplated by the underlying provisions of the American Recovery and Reinvestment Act of 2009, bonuses accrued or paid before the effective date of the new rule are not subject to the rule’s bonus payment limitation. In addition, separation pay for departures that occurred before receipt of TARP assistance also is not subject to the limits of the rule (even if payments continue to be made after effectiveness). The rule is not clear as to whether payments for departures that occur before effectiveness of the new rule, but after receipt of TARP assistance, may be continued.

Greater certainty of programs covered. The new rule clarifies that borrowers in the TALF (Term Asset-Backed Securities Loan Facility), minority investors in the PPIP (Public-Private Investment Program), participants in the Home Affordable Modification Program and minority investors in other TARP recipients are not subject to the compensation and corporate governance standards. For this purpose, the rule refers to applicable tax affiliation principles (but using 50% ownership as opposed to 80% for the tax rule).

Analysis of program coverage is highly technical and requires case-by-case review, particularly of any new structures or transactions involving government funding. In addition, the rule does not address the separate limits of the Employ American Workers Act on hiring non-U.S. employees.

Identifying “most highly compensated employees”—non-executives included. The rule’s definition of “most highly compensated employees” covers all employees, not only executive officers or other policy makers. As a result, proprietary traders, investment banking personnel and fund managers may be included.

The determination of the most highly compensated employees is based on annual compensation for the prior year calculated in accordance with SEC disclosure rules. Because these calculations are not intuitive, require equity valuation and generally have been limited to executives, it may take time to determine the group of covered employees and TARP recipients should begin immediately to identify them. In particular, limitations on separation payments, tax gross-ups and bonus accruals could be relevant immediately upon the rule’s effectiveness. The determination of most highly compensated employees is different for purposes of the limit on deductible compensation, and institutions therefore will need to track two separate groups. Any revisions to the SEC’s disclosure rules this year also could affect the determination of covered employees going forward.
Added flexibility on continuing equity compensation. The rule permits salary paid in property, including stock, so long as it is based on a dollar amount (not a number of shares), is fully vested and accrues as cash salary would. The rule also permits salary paid in stock units in respect of shares of the TARP recipient, or subsidiaries or divisions of the TARP recipient (though not below the subsidiary or division for which the employee directly provides services). Holding periods also are permitted.

Some commissions exempted, but programs frozen. Commission payments for sales, brokerage and asset management services for unrelated customers will not be subject to the bonus restrictions, but only if they are consistent with an existing plan of the TARP recipient in effect before February 17, 2009. TARP recipients that did not have such programs or that wish to adopt different programs (or acquire a company that has them) would need to do so in compliance with the restrictions on bonuses contained in the new rule. In addition, the exemption for commissions does not cover investment banking fees, proprietary trading or incentive compensation related to a specified transaction, and, depending on the circumstances, commissions from related parties may or may not be exempt under the rule.

Restrictive set of governance practices. The rule imposes a restrictive set of so-called best practices on TARP recipients:

- **Prohibition of tax gross-ups.** The five senior executive officers and the next 20 most highly compensated employees may not receive any tax “gross-up” payment of any kind, including payments to cover taxes due on company-provided benefits or separation payments.
- **Prohibition of change-in-control payments.** The prohibition on separation payments to the five senior executive officers and the next five most highly compensated employees is extended to payments in connection with a change in control.
- **Semi-annual review of all employee compensation plans and expanded certification.** The compensation committee must review all employee compensation plans every six months for unnecessary risk and provide an expanded certification including narrative disclosure of its analysis and conclusions.
- **Clawback must be pursued.** The rule mandates that TARP recipients must exercise their clawback rights unless doing so would be unreasonable.
- **Elimination of excessive or luxury expenditures.** TARP recipients must adopt a policy reasonably designed to eliminate excessive or luxury expenditures.

Positive clarification for acquisitions. Importantly, the rule clarifies that an institution will not become subject to the compensation standards merely as a result of acquiring a TARP recipient. In addition, if an acquiror is not subject to the standards immediately after the transaction, any employees of the acquiror (including former employees of the TARP recipient who become acquiror employees as a result of the transaction) will not be subject to the standards.

Potential for continuing limits. The “TARP period” during which the compensation standards apply ceases when the obligations arising from financial assistance cease and specifically excludes any period when the only outstanding obligation of a TARP recipient consists of Treasury warrants to purchase common stock. Confusingly, however, in a separate part of the rule, Treasury states that “an obligation...
includes the ownership by the Federal government of common stock of a TARP recipient.” It is unclear whether this is intended to include only common stock held as a result of the conversion of outstanding preferred stock (or if it also would encompass exercise of the warrant) and whether this interpretive rule is specific to certain sections of the guidance (or if it is more general).

**IMMEDIATE NEXT STEPS**

The Treasury rule suggests a number of tasks on which TARP recipients will need to take immediate action.

*Identify covered employees and review compensation compliance.* TARP recipients should begin immediately to identify their senior executive officers and covered “most highly compensated employees” and review their compensation for compliance with the rule, including:

- Restructuring compensation as a combination of an appropriate salary, which may include stock salary, and permissible restricted stock bonuses
- Analyzing whether compensation structures include prohibited tax gross-ups or “golden parachute” separation payments
- Analyzing whether deferred compensation plans contain provisions, such as vesting requirements, that could be viewed as impermissible bonus or retention payments
- Ensuring that required clawbacks are in place
- Analyzing perquisites, which will need to be disclosed and justified if they exceed $25,000 for any covered employee (which represents a significant expansion of current SEC disclosure rules)

*“Exceptional assistance” companies should prepare immediately to deal with the Special Master for TARP Executive Compensation.* The Special Master will be responsible for companies that have received exceptional assistance from the government, which include AIG, Citigroup, Bank of America, Chrysler, Chrysler Financial, GM and GMAC. Initial submissions of information on compensation and proposed payments are due within 60 days of the rule’s effectiveness.

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