



Treasury issues interim final rules setting executive compensation limits for TARP recipients

The Department of the Treasury has released an Interim Final Rule implementing the executive compensation restrictions that apply to companies receiving financial assistance under the Troubled Asset Relief Program (TARP). This Alert overviews the Interim Final Rule, which was published in the Federal Register on Monday, June 15, 2009.

The Interim Final Rule carries out the executive compensation rules established under the Emergency Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (AARA) and is generally effective as of June 15, 2009. Certain provisions have an earlier effective date, including a shareholder “say on pay” rules.

Implications

Companies subject to the TARP will need to carefully consider their existing compensation arrangements internal processes in order to take the actions that may be necessary to come into compliance. The Interim Final Rule imposes both substantive requirements that limit the terms and dollar amounts that may be paid to certain executives and process requirements that impose review and certifications by the compensation committees and the principal executive officer and principal financial officer. New tracking and identification systems likely will be needed to identify the potentially broader group of highly compensated employees, in addition to the senior executive officers. For example, payment of bonuses and other incentive pay that has already accrued during non-TARP periods may be precluded from being paid currently during the TARP period and, therefore will need to be carefully tracked to ensure that disqualifying payments do not occur or that the company does not inadvertently promise such payments to individuals who become subject to the limitations. Processes to enable the compensation committee to weigh and assess the inherent risks in executive compensation programs will need to be established so that the committee may satisfy a mandatory review of such programs every six months as well as provide a required annual narrative report on risk assessment and mitigation. The chief executive and principal financial officers are also required to personally certify the company’s adherence to the Interim Final Rules and the company is charged with recordkeeping requirements to substantiate such compliance. In light

of these provisions, companies that have received assistance under the TARP will need to put in place corporate governance and operational systems to ensure that such certifications can be made.

Summary

The Interim Final Rule is in the form of a lengthy notice that is set forth in a "Q&A" format and includes many new defined terms. The Interim Final Rule clarifies that, for periods prior to the effective date, the prior Treasury guidance issued under the EESA will continue to apply. In addition, the Interim Final Rule makes no changes to prior guidance issued under Internal Revenue Code Section 162(m)(5) for TARP recipients (the \$500,000 deduction limit) and the prior guidance continues to apply without change. The Interim Final Rule also states that with respect to the EESA requirement to provide a nonbinding shareholder resolution on executive compensation (i.e., "say on pay"), the SEC will promulgate such guidance. The following other statutory requirements under Section 111 of EESA (as amended by the AARA) are addressed:

- ▶ Compensation committee requirements to evaluate and review compensation to ensure that CEOs and others are not encouraged to take unnecessary and excessive risks;
- ▶ Imposition of a "clawback" provision for any compensation paid to a CEO or the next twenty most highly compensated employees based on materially inaccurate financial statements or performance metrics;
- ▶ Prohibition on all severance arrangements (referred to as "golden parachutes") for CEOs and the 5 most highly compensated employees;
- ▶ Prohibition on bonuses, retention awards and limitations on incentive payments for CEOs and other most highly compensated employees depending upon the level of financial assistance under TARP;
- ▶ Adoption and publication of an excessive and luxury expenditures policy; and
- ▶ Certification requirements by the principal executive officer and principal financial officer of the TARP recipient.

The Interim Final Rule includes four additional regulations promulgated under the general authority granted to the Department of the Treasury, which are:

- ▶ The establishment of a Special Master to approve and review the compensation programs of those companies that receive "exceptional financial assistance" under the TARP. Such review encompasses the compensation programs for all senior executive officers (SEOs), all executive officers, and the 100 most highly compensated employees. The Special Master also is granted authority to provide rulings and decisions on compliance to all other companies participating in TARP with respect to the application of the Interim Final Rule;
- ▶ The requirement for disclosure of all perquisites with a value of \$25,000 or more provided to any CEO or other highly compensated employee who is subject to the bonus limitations;
- ▶ The mandatory disclosure of all services provided by compensation consultants, including the disclosure of benchmarking and peer group analysis provided by such consultants;
- ▶ The prohibition on any "tax gross ups" or reimbursements for taxes paid for CEOs and the next 20 most highly compensated employees, with any exception for certain tax equalization payments made to employees who are U.S. taxpayers working outside the United States.

General Concepts

A “TARP recipient” is a company, regardless whether publicly or privately-held, that has received financial assistance under the provisions of EESA, including the sale of preferred stock to the Department of the Treasury. Whether an entity is a TARP recipient generally is determined under the controlled group principles of Section 414(b) and (c) but using a 50% instead of an 80% ownership threshold and generally disregarding the rules for brother-sister and combined controlled groups. In addition, if an entity that is a TARP recipient is acquired by an entity that is not a TARP recipient, the acquirer does not become subject to the Interim Final Rule. Moreover, any individual who becomes employed with the acquiror or its controlled group ceases to be subject to the executive compensation restrictions under the Interim Final Rule. Thus, the Interim Final Rule seeks to ensure that TARP recipients and any business units or divisions are not unattractive to potential buyers on account of the executive compensation restrictions that would otherwise apply.

The Interim Final Rules define an SEO under the standards for compensation reporting under Item 402 of the federal securities laws, which generally is the standard used for “proxy reporting.” Thus, the same senior executive officers who appear on a public company’s summary compensation table for the close of a fiscal year will be the SEOs subject to the Interim Final Rule. In addition, certain provisions of the Interim Final Rule apply to other “most highly compensated employees,” whose compensation will not have been determined for proxy reporting purposes. The Interim Final Rule provides that the same standard for calculating the compensation for proxy reporting is utilized for identifying the most highly compensated employees. In general, the proxy reporting standard measures compensation on the basis of the periods for which it accrues rather than when it is paid. Thus, the proxy reporting standard may yield very different results than if the most highly compensated employees were determined on the basis of the W-2 or federal income tax standard, which generally measures when compensation is actually paid and, therefore, includable in the individual’s income. Companies that are TARP recipients will need to establish mechanisms to capture “proxy-style” compensation data for a broader group of employees to ensure compliance. Private companies also are required to utilize the proxy reporting standards in making these determinations.

The Interim Final Rule imposes certain restrictions on executive compensation for the “TARP period.” The TARP period does not include any period in which only warrants to purchase common stock of the company are held by the Treasury. The TARP period begins on the first date of the receipt of the financial assistance under TARP and ends on the last date on which any obligation is outstanding; thus, the TARP period may cover partial years as companies become subject to the TARP restrictions or cease to be subject to the TARP restrictions.

Under the Interim Final Rule, compensation, including a bonus, is generally viewed as being paid “during the TARP period” if the legally binding right to the compensation arises during the TARP period. A “legally binding right” is defined using principles that apply under Code Section 409A (regulating the taxation of deferred compensation). In general, a legally binding right is merely an enforceable promise. The legally binding right arises when the enforceable promise is first made regardless that the right to receive the payment may be in a future year or contingent upon future services or upon other events that make the receipt of the payments subject to a risk of forfeiture or otherwise uncertain.

Compensation committee requirements to evaluate and review compensation to ensure that seos and others are not encouraged to take unnecessary and excessive risks

The Interim Final Rule requires that the compensation committee of a TARP recipient “discuss, evaluate and review” every six months all long term and short risks that affect the TARP recipient and (2) identify the feature of any CEO’s compensation and any employee compensation plan that could encourage behaviors that are not in the “long-term interest of value creation” or that would “encourage the manipulation of reported earnings.” Under the Interim Final Rule, an employee compensation plan is any compensation arrangement regardless whether an CEO participates. Thus, it appears that the Interim Final Rule charges the compensation committee with responsibility for plans that include no CEOs or other executives, which may expand the compensation committee’s role since they typically review only senior management programs.

After identifying any such risks with CEO compensation or other employee compensation arrangements, the compensation committee is required to take actions to limit any offending features and otherwise reduce any identified risks. The compensation committee’s review and evaluation must include a consultation with the company’s senior risk officer at least every six months.

The Interim Final Rule also sets forth specific compensation committee certifications that must be made ensuring that the required processes have been followed and these certifications must be disclosed as part of the Compensation Committee Report required under securities laws for public companies. (Specific rules are provided for certifications by non-public companies.) In addition to the specific certifications required, the compensation committee must provide and disclose an annual narrative describing its evaluation process and the steps that it has taken to identify and avoid risks and any potential to manipulation of earnings.

Imposition of a “clawback” provision for any compensation paid to a seo or the next twenty most highly compensated employees based on materially inaccurate financial statements or performance metrics

All TARP recipients must provide and enforce “clawback” provisions for any bonus payments made during the TARP period to an CEO or the next twenty most highly compensated employees that are determined to be the result of “materially inaccurate financial statements” or “any other materially inaccurate performance metric criteria.” As discussed below, some TARP companies are precluded from paying bonuses to this group altogether during the TARP period (other than certain incentive compensation). For purposes of applying the clawback provisions, a bonus is “made during the TARP period” if the legally binding right to the bonus arises during a TARP period, which as discussed, above, generally means that the promise to pay the bonus is made during a TARP period, even if the bonus not due or payable until a future year after the TARP period has ceased.

Prohibition on all severance arrangements (referred to as “golden parachutes”) for CEOs and the five most highly compensated employees and prohibition on tax “gross ups”

The Interim Final Rule clarifies that the prohibition on “golden parachutes” applies to all payments made solely on account of the individual’s departure or a change in control of the company; however, it does not include tax-qualified plan benefits or retirement or other benefits that have accrued for periods outside the TARP period and that would be made regardless whether the employee severs employment or the change in control occurs. Thus, the Interim Final Rule appears to distinguish between payments that arise solely on account of a severance and those benefits that accrue over the course of the employee’s providing

services but would merely be payable upon a severance or a change in control. It should be noted, however, that common contractual or plan provisions that accelerate vesting upon an involuntary termination or a change in control would violate the prohibition and amounts that would be paid as a result of such acceleration would be precluded. Many arrangements that would be precluded under this rule may also be prohibited under the bonus limitations discussed below.

The Interim Final Rule also adds a prohibition on any payment that is intended to “gross up” or reimburse an CEO or the next 20 most highly compensated employees for taxes incurred. Exceptions are provided for certain tax equalization payments that typically are provided to expatriate employees.

Prohibition on bonuses, retention awards and limitations on incentive payments for CEOs and other most highly compensated employees depending upon the level of financial assistance under TARP

The Interim Final Rule clarifies how the bonus prohibition applies to CEOs and other highly compensated employees of TARP recipients and further clarifies what “incentive compensation” is allowed as a specific exception to the bonus prohibition. The statutory rule under EESA prohibits bonuses from being paid or accrued during the TARP period, other than certain long-term restricted stock plans. The number of employees subject to the bonus prohibition is contingent upon the level of the company’s assistance during the TARP period:

<i>Level of TARP assistance</i>	<i>Employees whose bonuses are prohibited</i>
Under \$25,000,000	1 most highly compensated
Under \$250,000,000	5 most highly compensated
Under \$500,000,000	CEOs and 10 most highly compensated
More than \$500,000,000	CEOs and 20 most highly compensated

The levels of TARP financial assistance are determined as of the last day of the company’s fiscal year and take effect for the next fiscal year.

The Interim Final Rule specifically addresses how the bonus limitation applies currently to existing bonus plans, which has been a perplexing question for many TARP companies and their advisors particularly considering that companies may have already negotiated specific bonus payment rules as part of their agreements when entering into TARP. The Interim Final Rule takes what may be viewed as the most liberal reading of the statute and states that bonuses “paid or accrued” prior to June 15, 2009, are not subject to the bonus prohibition. If the accrual of a bonus payment spans a period beginning before June 15, 2009, and after such date, the bonus payment will not violate the prohibition if reduced to reflect only the period prior to June 15, 2009. In addition, any bonus that is paid or accrued after June 15, 2009, but is eligible for the statutory “grandfather” rule also is not subject to the prohibition. Under the Interim Final Rule, the grandfather rule applies to any “legally binding right” that arose on or before February 11, 2009. Again, a legally binding right is a mere promise to pay although it must be a promise that is enforceable. Many questions had arisen as to the scope of the grandfather because the statute refers only to a “valid employment contract.” The Interim Final Rule treats any contract, tax-qualified plan (e.g., 401(k)) or a nonqualified deferred compensation plan in effect on February 11, 2009 as a contract for these purposes although the particular grant must have also been legally binding as of that date. The combination of the Interim Final Rule’s effective date and interpretation of the grandfather

rule limit the potential scope of the bonus prohibition. Nonetheless, TARP companies will need to carefully examine existing grants to determine whether discretionary grants were made after the February 11, 2009, and therefore not subject to the grandfather rule and whether pre- June 15, 2009 grants must be reduced to avoid accruals for the post June 15, 2009 service period. It appears that bonuses already paid as of June 15, 2009, however, escape the bonus prohibition altogether.

For companies that become TARP recipients in the future, the prohibition against bonus payments or accruals applies as of the first date of the TARP period. Thus, even if a bonus is fully earned by an SEO or highly compensated employee for the period prior to the TARP, once the TARP period begins such bonus cannot be paid until the TARP period is completed.

In order to apply these rules, the central interpretive issues are how to define a bonus and how to assign a bonus to a period of accrual. The Interim Final Rule generally looks to the form in which amounts are paid to determine whether a right to compensation is a bonus. Any amount paid "in addition to the employees' regular hourly, daily, weekly, monthly or similar periodic rate" generally will be viewed as a bonus other than qualified plan contributions and accruals, overtime, and routine expense reimbursements. Thus, the prohibition on bonuses does not preclude increases in salary (although in some cases the Special Master may be required to approve such payments as discussed below.) Commissions generally are not treated as bonuses, which will be of significant help to those TARP companies that maintain an agent sales force. The Interim Final Rule includes specific definitions for "commissions," which are designed to ensure that the exception is limited to commissions paid in the ordinary course primarily for sales to unrelated parties. A prohibited bonus specifically includes any retention award or incentive compensation unless designed as long-term restricted stock (see below). Even if a bonus is "performance-based" and requires the SEO or other highly compensated employee to satisfy performance goals, it will be precluded under the Interim Final Rule unless it satisfies the long-term restricted stock exception. This prohibition on incentive pay would include, for example, typical stock option and appreciation rights plans as well as performance-based cash plans and other accruals or accretions in nonqualified deferred compensation plans that are not otherwise grandfathered.

In determining for what period a bonus accrues, the Interim Final Rule prescribes a facts and circumstances test. A bonus that is calculated to take into account a service period that includes the TARP period must be treated as accruing during the TARP period. Thus, an accretion under a nonqualified deferred compensation plan, such as a supplemental pension plan generally would be precluded during the TARP period. If a bonus or any other form of compensation increase is granted after the close of the TARP period to an individual who was an SEO or affected highly compensated employee during the TARP period, it also may be precluded from being paid if, in effect, the "new" bonus or payment substitutes for a bonus that otherwise could not have accrued during the TARP period. If a bonus accrues for a multi-year service period, the bonus may be reduced to reflect the TARP period and be treated as not violating the prohibition on bonuses, provided that such bonus is not paid until the close of the TARP period.

The only readily available method for providing bonuses or incentives to the affected SEOs or employee for the TARP period is through the use of long-term restricted stock. A long-term restricted stock plan may be provided to the SEOs and affected highly compensated employees if the award does not exceed 1/3 of the individual's annual compensation and meets certain vesting requirements. For these purposes, the Interim Final Rule defines a

long-term restricted stock plan as either a grant of restricted stock or a restricted stock unit that is settled either in stock or cash and generally utilizes principles that define "service recipient stock" under Code Section 409A. Annual compensation is measured using the accrual methodology under the proxy reporting rules, as discussed above, but it is measured on the basis of the current fiscal year and not using a look-back method on the basis of the prior year. The long-term restricted stock (or stock unit) is valued as of the date of grant on the basis of the fair market value of the stock.

The Interim Final Rule requires that the long-term restricted stock be subject to a vesting requirement of at least two years. The long-term restricted stock may not be payable (with respect to stock units) or be transferable (with respect to stock) unless and until the company repays a certain percentage of the TARP funds. The Interim Final Rule provides a schedule for payment or transferability that generally lifts these restrictions in 25% increments based on the company's repayments. For example, 25% of the stock may become transferable at the time that the company repays 25% of the TARP funds; an additional 25% at the time the company repays 50% of the TARP funds; etc. Limited exceptions are provided from the limitations on transferability or distribution, such as an exception allowing a transfer of stock to the extent necessary to sell shares to pay employment taxes when restricted stock vests after the required minimum two-year period and, therefore is subject to income inclusion under Code Section 83(a), but is not yet otherwise transferable because the TARP funds have not yet been repaid. Similarly, relief is provided under Section 409A (including the exception for short-term deferral payments) for a delay in payment when a restricted stock unit vests but cannot be paid out because the TARP funds have not yet been repaid.

Adoption and publication of an excessive and luxury expenditures policy, perquisites and compensation consultant disclosures

No later than 90 days after becoming a TARP recipient (or September 13, 2009 for existing TARP companies), the board of directors of the company must adopt and administer an excessive or luxury expenditures policy. The Interim Final Rule defines the policy as one that addresses (1) entertainment or events; (2) office or facility renovations; (3) aviation or other transportation services; and (4) similar items activities or events reasonably anticipated to occur and to generate employee reimbursement. The policy must be written, address these four standards and identify those reimbursements that are prohibited and those that require prior approval and establish procedures for such approval. In addition, the principal executive officer and principal financial officer must approve any expenditure of an SEO that requires prior approval or the board of directors must approve such expenditure. The policy must mandate adherence to the policy and provide accountability for failure to adhere. The policy must be posted on the company's website and be maintained through the TARP period.

In addition to a policy on expenditures, the Interim Final Rule adds an additional requirement that TARP recipients annually disclose any perquisite paid with a total value of \$25,000 to any SEO or any highly compensated employee that is subject to the bonus prohibition. The disclosure must provide a narrative description identifying the nature and reason for the payment, the recipient, and the justification for making such payment.

Further annual disclosure is required as to whether the company, the board of directors or the compensation committee has engaged the services of any compensation consultant and the nature of the services. This disclosure requires a description of "all types of services" that have been provided by the consultant and any of its affiliates including non-compensation related services during the past three years. The Interim Final Rule specifically states that any

“benchmarking” or peer group comparisons of employee compensation must be disclosed including the lowest percentile levels of compensation proposed. This disclosure takes effect within 120 days of completion any fiscal year that includes a TARP period.

Certification requirements by the principal executive officer and principal financial officer of the TARP recipient

The principal executive officer and principal financial officer must personally certify that all EESA requirements, as discussed above, have been satisfied generally within 90 days after each fiscal year that includes a TARP period. The certification generally must take the form as provided in the Interim Final Rule, which includes 16 specific statements and disclosures designed to show compliance with all applicable rules under EESA. The certification generally must be included as an exhibit to the company’s annual proxy report. The Interim Final Rule imposes a recordkeeping requirement as necessary to substantiate all items that are certified. The Interim Final Rule also states that false or fraudulent certifications are subject to criminal sanctions.

Creation of the “Special Master”

The Interim Final Rule creates the Office of the Special Master for TARP Executive Compensation (Special Master). The Special Master has specific duties and authority with respect to those TARP companies that have received “exceptional financial assistance,” which includes the Programs for Systemically Significant Failing Institutions, the Targeted Investment Program, the Automotive Industry Financing Program, and any other program determined by Treasury at a later date. In general, the Special Master must approve all payments to CEOs and affected highly compensated employees and approve all “compensation structures” (i.e., design, terms and conditions) for all executive officers or any of the 100 most highly compensated employees. These approvals may include awards that have fully accrued but not yet been paid. No Special Master approval is required, however, to the extent any employee’s annual compensation has been limited to \$500,000 or less and any incentive pay is made in the form of long-term restricted stock (in the form discussed above under bonus prohibitions).

In addition to the obligations of the Special Master for companies that have received exceptional financial assistance under TARP, the Special Master has interpretive authority for the Interim Final Rule and all other applicable rules under EESA. Individual companies may submit requests to the Special Master for guidance and advisory opinions.

The Special Master also is charged with reviewing all pre-February 17, 2009 payments to determine whether any such payments were inconsistent with the then-existing rules under EESA. The Interim Final Rule sets forth principles under which the Special Master will make such determinations and negotiate any actions to pursue repayments from employees.

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