

Treasury Unveils ARRA Executive Compensation and Corporate Governance Standards

The June 2009 Rules describe how financial institutions receiving assistance under TARP are to comply with the executive compensation and corporate governance standards.

On June 10, 2009, the U.S. Department of the Treasury (“Treasury”) issued an Interim Final Rule (the “June 2009 Rules”) describing how financial institutions receiving assistance under the Troubled Assets Relief Program (“TARP”) are to comply with the executive compensation and corporate governance standards imposed by the Emergency Economic Stabilization Act of 2008 (“EESA”), as amended by the American Recovery and Reinvestment Act of 2009 (as amended, the “ARRA standards”).

Executive Summary

The June 2009 Rules became effective on June 15, 2009. Through the June 2009 Rules, the Treasury:

- Supersedes Prior Guidance. Supersedes and replaces its prior Interim Final Rules and other compensation-related guidance issued under TARP.
- Imposes Limitations on Executive Compensation. Imposes limitations on the executive compensation practices of TARP recipients by:
 - Limiting the deductibility of compensation of senior executive officers (“SEOs”) in excess of \$500,000;
 - Prohibiting bonus payments to certain SEOs and other most highly-compensated employees (“MHCEs”) based on the amount of TARP assistance received;
 - Curtailing the payment of “golden parachute payments” upon a departure or change in control of the TARP recipient; and
 - Imposing a clawback for bonus payments based on materially inaccurate performance criteria.
- Appoints a Special Master for TARP Executive Compensation. Appoints a Special Master for TARP Executive Compensation (“Special Master”) with the authority to:
 - Review and approve compensation for SEOs and the 20 next MHCEs of any TARP recipient receiving exceptional assistance¹;
 - Review and approve the compensation structure for SEOs and the 100 next MHCEs for any TARP recipient receiving exceptional assistance; and
 - Review and seek reimbursement for certain bonus payments made prior to February 17, 2009.
- Implements Governance Standards. Implements governance standards requiring that TARP recipients:
 - Establish a compensation committee consisting of independent directors and that this committee engage in risk analysis of CEO and all other

¹ Note: The Capital Purchase Program is *not* considered to be a program under which TARP recipients have received “exceptional assistance.”

employee compensation plans and provide certifications regarding the same;

- Adopt a policy on luxury or excessive expenditures and require that certain corporate officers provide certifications regarding the same.
- Permit an annual “Say on Pay” shareholder vote on compensation.
- Imposes Additional Compensation and Corporate Governance Standards. Imposes additional compensation and corporate governance standards:
 - Prohibiting TARP recipients from providing “gross-ups” to CEOs or the 20 next MHCEs;
 - Requiring disclosure of perquisites in excess of \$25,000 and a justification for offering such perquisites; and
 - Mandating disclosure of the use of compensation consultants.

Detailed Overview of June 2009 Rules

The ARRA standards require that TARP recipients comply with a number of governance and compensation standards “to be established by the Secretary of the Treasury”. The June 2009 Rules establish these standards and provide much needed guidance on their application. The remainder of this Memorandum summarizes the ARRA standards, identifies the significant clarifications and expansions of the standards made by the Treasury in the June 2009 Rules, and provides practical observations regarding the application of the standards.

Prior Rules Superseded

Treasury established TARP for the purpose of providing assistance to financial institutions and other entities. As a condition to receiving this assistance, TARP recipients were required to comply with various restrictions on their executive compensation practices imposed by EESA and described in Interim Final Rules issued by the Treasury in October 2008. The Treasury amended these rules in January 2009 and issued comprehensive guidance on the EESA executive compensation restrictions in February 2009.

The ARRA standards amended and replaced the EESA executive compensation restrictions in their entirety and the June 2009 Rules supersede and replace the October 2008 Interim Final Rules, the January 2009 amendments to those rules, and the February 2009 guidance. The June 2009 Rules became effective on June 15, 2009.

Executive Compensation Restrictions

The June 2009 Rules provide that:

- \$500,000 Limit on Deductible Compensation. TARP recipients may not claim a deduction for compensation paid to CEOs in excess of \$500,000.

Observation: This is the same limitation, contained in the original EESA executive compensation restrictions. The June 2009 Rules do not alter these rules.
- Prohibition on Golden Parachute Payments. TARP recipients are prohibited from making any golden parachute payment to CEOs or any of the five next MHCEs.

Golden Parachute Defined: The June 2009 Rules define a “golden parachute payment” as any payment upon a departure from a TARP recipient for any reason or due to a change in control of the TARP recipient.

Observation: A golden parachute includes accelerated vesting, making “single trigger” change in control termination agreements subject to the prohibition.

Exclusion for Payments for Services Performed or Benefits Accrued: The definition of a golden parachute payment excludes “payments for services performed or benefits accrued”. Payments for current or prior services are considered to be payments for services performed or benefits accrued. Generally, a payment for current or prior services is a payment that will be made regardless of whether the employee departs or a change in control occurs, or is due regardless of whether the employee’s departure is voluntary or involuntary.

Observation: This exclusion allows TARP recipients to make payments that vested prior to the TARP period.

Relationship to Deferred Compensation: Payments from a benefit or deferred compensation plan may be treated as payments for services performed or benefits accrued if (a) the plan was in effect for at least one year prior to the employee’s departure, (b) payment is made pursuant to the plan as in effect no later than one year prior to the departure, disregarding any amendment during this period increasing benefits, (c) the employee had a vested right to payment at the time of departure or the change in control, (d) benefits accrue only for current or prior services rendered, (e) payment is not based on discretionary acceleration of vesting or accruals occurring within one year prior to departure or the change in control, and (f) with respect to deferred compensation, the TARP recipient previously recognized a compensation expense and accrued a liability, or segregated assets in a rabbi trust, for payment.

Payment Timing Rule: Golden parachutes are treated as being paid at the time of departure or following the change in control.

Observation: The payment timing rule means that payments delayed until after the TARP period nevertheless may be subject to the prohibition.

- **Prohibition on Bonuses.** TARP recipients are prohibited from paying or accruing any bonus payment to a specified number of employees based on the amount of TARP assistance received, as set forth in the table below.

Financial Assistance Provided to TARP Recipient	Application of Prohibition on Bonuses
Less than \$25M	Only the most highly-compensated employee
\$25M but less than \$250M	At least the five most highly-compensated employees
\$250M but less than \$500M	SEOs and at least 10 next most highly-compensated employees
\$500M or more	SEOs and at least 20 next most highly-compensated employees

Observation: The prohibition on bonus payments does not automatically include SEOs of TARP recipients receiving up to \$250M of TARP assistance.

Definition of Bonus Payment: The June 2009 Rules define “bonus payment” to include “bonuses” (any payment in addition to regular payments for services performed at a periodic rate), “incentive compensation” (payments under an incentive plan, stock or options, or equity-based compensation such as restricted stock units or stock appreciation rights), and “retention awards” (payments that are in addition to regular payments at a periodic rate for services performed, contingent on future services or the completion of a specific project or activity and not based on performance).

Observation: The prohibition on bonus payments does not apply to bonuses paid or accrued prior to the TARP period

Observation: Signing bonuses and “make whole” awards are retention awards.

Observation: The definition of bonus payment does not include certain commissions based on the direct sale of financial products to unrelated customers or volume of assets under management that, historically, are viewed as a component of base salary. This exception does not extend to fees earned from sales to entities within the affiliated group, investment banking or proprietary trading.

Observation: The definition of bonus payments does not apply to the accrual of deferred compensation unless the plan has been amended to materially enhance benefits or to make an employee eligible to participate, and such benefits are contingent on future service.

Observation: The inclusion of stock plans in the definition of bonus payment is not intended to restrict a TARP recipient’s ability to pay salary or other permissible payments in the form of stock or other property, even if stock is issued pursuant to a stock plan or is subject to a holding period or restriction on transferability. However, the payment must be of salary or another permissible payment. This means that payment must be denominated in dollars, the stock or property cannot be subject to a substantial risk of forfeiture or a requirement to perform future services, and the amount of stock or property must accrue at the same time the salary or other permissible payment would otherwise have been paid.

Definition of Accrual: The accrual of a bonus payment includes the granting of service credit or credit for compensation that an employee would have received but for the application of the ARRA standards, including retroactively after the employee ceases to be a SEO or MHCE.

Valid Employment Contract Exception: Bonuses required to be paid pursuant to a valid employment contract executed on or before February 11, 2009 are not bonus payments, if the employee had a legally binding right to payment under the contract.

Observation: The definition of valid employment contract includes not only employment agreements, but any other plan under which the employee had a legally binding right to payment that is (or would be) considered a material contract for federal securities laws purposes, including bonus and stock plans.

Observation: This exception does not apply if the contract is amended on or after February 11, 2009 to increase the amount payable, accelerate vesting or materially enhance the benefit.

Restricted Stock Exception: TARP recipients may grant long-term restricted stock with a value that does not exceed 1/3rd of the employee's total annual compensation. For this purpose, "long-term restricted stock" is restricted stock or restricted stock units (a) issued with respect to common stock of the TARP recipient, (b) transferable or payable only in connection with the repayment of TARP assistance by the TARP recipient in accordance with the schedule below, and (c) subject to forfeiture unless the employee continues providing substantial services for at least two years following the grant date.

Percentage Repayment by TARP Recipient	Percentage of Long-Term Restricted Stock Transferable or Payable
25%	25%
50%	Additional 25%
75%	Additional 25%
100%	Additional 25%

Observation: The June 2009 Rules expand the ARRA standards to allow TARP recipients to issue either restricted stock or restricted stock units.

- **Clawback.** Any bonus payment made to a SEO or any of the 20 next MHCEs is subject to clawback if based on materially inaccurate financial statements or performance metric criteria. For this purpose, a financial statement or performance metric criterion is materially inaccurate with respect to an employee who knowingly engaged in providing (or failing to timely correct) inaccurate information relating to the financial statement or performance metric criterion.

Observation: TARP recipients are required to exercise their clawback rights unless it would be unreasonable to do so.

Observation: There is no limit to the recovery period during which the clawback applies.

Corporate Governance Standards

The June 2009 Rules provide that:

- Establishment of Compensation Committee. TARP recipients must establish a “compensation committee” consisting of independent directors within 90 days after the effective date of the June 2009 Rules.

Observation: TARP recipients that received \$25M or less in TARP assistance may either establish a compensation committee or delegate the duties of the compensation committee to the board of directors.

Duties of Compensation Committee: The compensation committee (a) must engage in the periodic review of CEO and employee compensation plans described below, (b) certify the completion of these reviews, and (c) provide certain disclosures regarding CEO and employee compensation plans and describe how these plans comply with the requirements described below.

Observation: The disclosures and certifications are provided as part of the compensation committee report of the TARP recipient’s annual proxy statement, if the TARP recipient’s securities are publicly-traded. The June 2009 Rules contain a model certification.

Observation: The review of CEO and employee compensation plans is made with the TARP recipient’s senior risk officer.

- No Compensation Plans that Encourage Manipulation of Earnings. TARP recipients are prohibited from maintaining any employee compensation plan that would encourage the manipulation of reported earnings to enhance the compensation of any employee. The compensation committee must discuss, evaluate and review the employee compensation plans with senior risk officers at least every six months.

Observation: This standard applies to all employee compensation plans, not just those plans limited to CEOs or MHCEs.

- No Unnecessary Risk. TARP recipients cannot maintain compensation programs that encourage CEOs to take unnecessary and excessive risks that threaten the value of the institution. The compensation committee must discuss, evaluate and review these plans with senior risk officers at least every six months and discuss, evaluate and review any risk that the TARP recipient faces that could threaten its value, identify the features of CEO compensation plans that could lead CEOs to take these risks, identify the features in the plans that encourage behavior focused on short-term results and not on long-term value creation, and limit these features.
- Limitation on Luxury Expenditures. The board of directors of a TARP recipient must establish a company-wide policy regarding excessive or luxury expenditures within 90 days after the effective date of the June 2009 Rules, provide the policy to the Treasury and post the policy on its website.

Definition of Excessive or Luxury Expenditures: The June 2009 Rules define “excessive or luxury expenditures” as excessive expenditures (other than reasonable expenditures for staff development, reasonable performance incentives or similar reasonable measures conducted in the normal course of business) on entertainment or events, office and facility renovations, aviation or other transportation services, and other similar items, activities or events for which the TARP recipient may incur an expense or reimburse an employee.

Policy Requirements: The policy must identify prohibited expenditures and expenditures for which prior approval is required, provide reasonable approval procedures under which expenditures requiring prior approval may be approved, require certification by the principal executive officer (“PEO”) and principal financial officer (“PFO”) that any required approval was obtained, require internal reporting of violations to an appropriate designated person, and mandate accountability for adherence to the policy.

- Nonbinding Say on Pay. The annual proxy statement of TARP recipients must permit a nonbinding “Say on Pay” shareholder vote to approve the compensation of executives.

Observation: On February 24, 2009, the Securities and Exchange Commission issued rules describing how to comply with Say on Pay. The June 2009 Rules do not alter these rules.

- Certification of Compliance. The PEO and PFO of TARP recipients must provide a written certification of compliance with TARP.

Timing and Location of Certifications: Certifications must be provided within 90 days after the close of the fiscal year and are to be included as an exhibit (Exhibit 99) to the TARP recipient’s Annual Report on Form 10-K, if the TARP recipient’s securities are publicly traded. The June 2009 Rules contain model certifications.

Observation: The TARP recipient must preserve appropriate documentation and records to substantiate each certification for at least six years after the date of certification (and, for the first two years of this six-year period, in an easily accessible place) and provide such documentation and records to the Treasury promptly upon request.

Observation: False or fraudulent certifications may result in criminal liability.

Other Special Rules

In the June 2009 Rules, the Treasury exercised its discretionary authority to prescribe additional compensation and corporate governance standards requiring that:

- Disclose Perquisites: TARP recipients disclose any perquisite whose total value exceeds \$25,000 for the fiscal year for all employees subject to the prohibition on bonus payments and, within 120 days after the end of the fiscal

year, provide a description of the amount and nature of the perquisites and a justification for offering the perquisites.

Observation: The disclosure and justification must be provided to the Treasury and the TARP recipient's primary regulatory agency.

- Disclose Compensation Consultants: The compensation committee disclose, within 120 days after the end of the fiscal year, the use of any compensation consultants and the terms of compensation and non-compensation related services provided by such compensation consultants during the past three years.

Observation: The disclosure and justification must be provided to the Treasury and the TARP recipient's primary regulatory agency.

- Prohibit Gross-Ups: TARP recipients prohibit the provision of gross-ups to CEOs or the 20 next MHCEs during the TARP period.

Observation: The prohibition on gross-ups extends to the right to receive a gross-up at a later date.

- Acquisition of a TARP Recipient: The acquisition of a TARP recipient, including an acquisition of substantially all of the assets of a TARP recipient, does not cause the acquirer to become subject to the ARRA standards unless the primary purpose of the acquisition is to evade the ARRA standards.

Special Master for TARP Executive Compensation

The June 2009 Rules create the Office of the Special Master for TARP Executive Compensation. The Special Master is:

- Authority: Responsible for interpreting the ARRA standards, the June 2009 Rules and any other guidance, and may provide advisory opinions.
- Review of Prior Bonuses: Authorized to review bonuses, retention awards and other compensation paid prior to February 17, 2009 by TARP recipients to CEOs and their 20 next MHCEs to determine whether payment was inconsistent with the ARRA standards, the TARP, or otherwise contrary to public interest. If so, the Special Master will seek reimbursement of such amounts.

Observation: The June 2009 Rules create a framework that the Special Master will use to review prior bonuses that balances the elements and structures of the compensation programs under which payment was made. It is likely that this framework will be used to evaluate TARP recipients' ongoing compensation structure.

- Review and Approve Compensation of TARP Recipients Receiving Exceptional Financial Assistance. With respect to TARP recipients receiving exceptional financial assistance, responsible for reviewing and approving (a) the compensation payable to employees subject to the prohibition on bonus payments and (b) the compensation structure applicable to all other executive officers and the 100 next MHCEs.

Observation: The June 2009 Rules contain a compensation safe harbor that exempts certain compensation from review and approval by the Special Master. This safe harbor applies if total annual compensation to an employee does not exceed \$500,000 with any additional compensation payable in long-term restricted stock.

Definitions

For purposes of implementing the June 2009 Rules:

- “TARP recipient.” The “TARP recipient” includes any entity owning a 50% or greater interest in the TARP recipient or any entity in which the TARP recipient owns a 50% or greater interest. Certain brother-sister and combined group relationships are, however, disregarded.

Observation: Holding companies and their subsidiaries generally will be considered to be TARP recipients.

Observation: The TARP recipient also includes any entity created or used for the purpose of avoiding the ARRA standards.

- “Senior Executive Officers.” References to a TARP recipient’s SEOs are to its named executive officers.

Observation: Smaller reporting companies generally are required to identify five SEOs, even if only three named executive officers are required to be identified for federal securities laws purposes.

- “Most Highly Compensated Employees.” A TARP recipient determines its MHCEs by reference to total annual compensation, determined without regard to whether such compensation is includible in gross income or reported on Form W-2.

Observation: Unlike the proxy disclosure rules, a former employee who is no longer employed on the first day of the relevant fiscal year is not a MHCE, unless it is reasonably anticipated that the employee will return during such year.

- “TARP period.” The TARP period begins on the date the TARP recipient receives TARP assistance and ends on the last date that any TARP obligation remains outstanding, but does not include any period during which the Treasury holds only warrants to purchase common stock of the TARP recipient.

Observation: The definition of TARP period makes a number of the ARRA standards retroactively applicable.

If you have any questions, please contact one of the following, or your Vorys relationship attorney:

Terri R. Abare
trabare@vorys.com
513.723.4001

Anthony C. Ciriaco
acciriaco@vorys.com
614.464.6429

Alan D. Duffy
adduffy@vorys.com
614.464.5425

Elizabeth T. Farrar
etfarrar@vorys.com
614.464.5607

Jason L. Hodges
jlhodges@vorys.com
513.723.8590

Kimberly J. Schaefer
kjschaefer@vorys.com
513.723.4068

Cynthia A. Shafer
cashafes@vorys.com
513.723.4009

Amy S. Swank
aswank@vorys.com
614.464.6461

J. Bret Treier
jbtreier@vorys.com
330.208.1015

John C. Vorys
jcvorys@vorys.com
614.464.6211

Yolanda C. Vorys
ycvorys@vorys.com
614.464.6428

Anthony D. Weis
adweis@vorys.com
614.464.5465

Recommendations

Any TARP recipient subject to the ARRA standards should consider all of the following:

- **Identify Affected Employees.** Identify SEOs and MHCEs affected by the ARRA standards to ensure that these employees do not accrue or receive any payments of compensation prohibited by the ARRA standards.
- **Enter into Letter Agreements with Affected Employees.** Enter into letter agreements with affected employees obtaining their consent to amend any compensatory plan to the extent necessary to give effect to the June 2009 Rules and agreement to cooperate with the implementation of any other requirement of the ARRA standards.
- **Review Compensation Structure.** Review the structure and elements of compensation of each affected employee, identify the payment(s) prohibited or required to be disclosed under the ARRA standards, and consider alternative compensatory arrangements that comply with these standards.
- **Evaluate Equity Plans.** Evaluate equity plans to determine whether restricted stock or restricted stock units are available for grant, including whether awards can be granted subject to the vesting and settlement conditions required by the June 2009 Rules.
- **Consider Impact of Code Section 409A.** Consult with compensation counsel to determine the impact of Section 409A of the Internal Revenue Code of 1986 on bonuses earned in prior fiscal years but that were not paid during the pendency of the ARRA standards and on the modification of other compensatory arrangements to comply with the ARRA standards.
- **Compensation Committee Composition and Education.** Establish a compensation committee (or ensure that existing compensation committee composition satisfies the ARRA standards) and educate compensation committee members about their responsibilities under the ARRA standards.
- **Develop Appropriate Policies.** Develop an appropriate luxury expenditure policy, giving consideration to the categories of expenditures affected, approval requirements, and reporting procedures to ensure compliance. Consider amending existing record retention policy to ensure retention of documents and records relating to certifications and disclosures made to comply with the ARRA standards.
- **Provide Required Certifications.** Ensure that the certifications required by the ARRA standard are timely made.

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