United States Treasury Issues Interim Rules Regarding Executive Compensation Provisions of the Capital Purchase Program Established Under the Emergency Economic Stabilization Act of 2008

Impact Likely to Extend Beyond Financial Institutions

Financial institutions participating in the CPP are subject to a number of new limitations on their executive compensation practices.

New Executive Compensation Standards for Participants in Treasury's Capital Purchase Program

The U.S. Department of the Treasury ("Treasury") recently issued interim final rules providing guidance on the executive compensation provisions applicable to participants in the Capital Purchase Program ("CPP") of the Troubled Assets Relief Program ("TARP") established under the Emergency Economic Stabilization Act of 2008 ("EESA"). Under the CPP, the Treasury will provide equity capital on standardized terms directly to participating financial institutions (or, in the case of a financial institution with a parent holding company, that financial institution's parent holding company [hereinafter each is referred to as a "financial institution"]) in exchange for senior preferred stock and warrants to purchase common stock of the financial institution. During the period of time in which the Treasury holds an equity or debt position in the financial institution, any financial institution participating in the CPP, as well as each other entity having a parent-subsidiary relationship with the participating financial institution, must conform the compensation arrangements with senior executive officers ("SEOs") to the standards described below. The financial institution's SEOs include the Principal Executive Officer, the Principal Financial Officer, and the next three mostly highly compensated executive officers. The executive compensation and governance standards imposed by the CPP require the financial institution to comply with all of the following:

- ***Avoid Incentives to Take Unnecessary and Excessive Risks.*** Financial institutions participating in the CPP must limit their compensation programs to prevent SEOs from taking "unnecessary and excessive risks that threaten the value of the financial institution" during the period that the Treasury holds an equity or debt position in the financial institution. In order to comply with this rule, the compensation committee of the participating financial institution must: (i) promptly, and in no case more than 90 days, after the purchase by the Treasury under the CPP, review SEO incentive compensation arrangements with senior risk officers to ensure that these arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution; (ii) at least annually, thereafter, discuss and review the relationship between risk management policies and practices and SEO incentive compensation arrangements; and (iii) certify that it has completed the initial and annual reviews. The certification is to be included in the Compensation Discussion and Analysis ("CD&A") required for financial institutions with securities registered with the Securities and Exchange Commission ("SEC") or provided to the financial institution's primary regulatory agency, in the case of financial institutions whose securities are not registered with the SEC. No bright line list of risks that fall into the category of "unnecessary and excessive" has been identified. However, the interim rules provide that the compensation committee

As a condition to participating in the CPP, a financial institution must amend or terminate its executive compensation arrangements to the extent necessary to comply with the CPP limitations.

should discuss with the senior risk officers, the risks (including long-term as well as short-term risks) that the financial institution faces that could threaten its value and should identify the features in the financial institution's SEO incentive compensation arrangements that could lead SEOs to take such risks.

- ***Clawback.*** Financial institutions participating in the CPP must subject all bonus or incentive compensation paid to an SEO during the period that the Treasury holds an equity or debt position in the financial institution to recovery or "clawback" if the payments were based on "materially inaccurate financial statements" or any other "materially inaccurate performance metric criteria." The circumstances requiring a clawback are broader under the CPP than under Section 304 of the Sarbanes-Oxley Act of 2002 in the following significant respects: (i) the category of officers whose compensation may be reclaimed is expanded to include the three mostly highly compensated executive officers, in addition to the Principal Executive Officer and Principal Financial Officer; (ii) both public and private financial institutions are covered; (iii) the recovery period is not limited; and (iv) the circumstances triggering the right to recovery are not limited to material inaccuracies related to financial reporting.
- ***Prohibit Excess Parachute Payments.*** Financial institutions participating in the CPP are prohibited from making excess parachute payments to an SEO during the period that the Treasury holds an equity or debt position in the financial institution. An "excess parachute payment" is any payment to (or for the benefit of) an SEO made on account of an applicable severance from employment to the extent the aggregate present value of the payments is equal to or exceeds three times the SEO's average annual compensation over the past five years. An "applicable severance from employment" is any severance by the SEO (i) by reason of involuntary termination of employment with the financial institution, or (ii) in connection with any bankruptcy filing, insolvency or receivership of the financial institution. A payment is not considered an excess parachute payment if the payment would have been made regardless of whether the applicable severance from employment occurred. For example, the payment of vested retirement benefits or vested elective deferred compensation that would be payable upon any termination would not constitute an excess parachute payment.
- ***Limit on Deductible Compensation.*** Financial institutions participating in the CPP may not claim a deduction for executive remuneration or deferred executive remuneration paid to an SEO in excess of $500,000 during the period that the Treasury holds an equity or debt position in the financial institution as though Section 162(m)(5), added to the U. S. Internal Revenue Code ("Code") by EESA, applied. For this purpose, "executive remuneration" includes all compensation paid to the executive for the applicable taxable year, including certain qualified performance-based compensation normally deductible under Section 162(m) of the Code, and "deferred executive remuneration" includes compensation that would be executive remuneration but for the fact that a deduction is allowable in a later taxable year (such as for amounts deferred under a deferred compensation plan). The $500,000 limit and the compensation paid to the SEO may be pro-rated for the portion of the taxable year that the Treasury holds an equity or debt position in the financial institution.

Under the CPP term sheet released by the Treasury, as a condition to the closing of the Treasury's investment, the financial institution and its SEOs must modify or terminate existing benefit plans, arrangements and agreements (including golden parachute agreements) to the extent necessary to comply with the

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foregoing standards. Following the closing and for so long as the Treasury holds any equity or debt securities of the financial institution, the financial institution must also agree to be bound by the foregoing standards. The CPP term sheet also requires financial institutions and their SEOs to grant waivers to the Treasury releasing it from any claims they might have arising from the implementation of the standards.

Treatment of Acquisitions

Significantly, if a financial institution participating in the CPP is acquired by an unrelated entity, the acquiror will not become subject to EESA (and the terms of the CPP) merely as a result of the acquisition. However, the SEOs of the acquired financial institution remain subject to the terms of the CPP until the first anniversary following the acquisition.

Implications for Non-Participating Financial Institutions and Other Public Companies As Well

In a speech entitled "Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009" presented at The 3rd Annual Proxy Disclosure Conference held on October 21, 2008, John W. White, Director of the Division of Corporation Finance at the SEC, commented that the standards applicable to participants in the CPP may impact executive compensation decisions and disclosures generally, not just those of financial institutions participating in the CPP. In particular, he offered the following thoughts:

- "Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target -- with risk, in this case, being viewed in the context of the enterprise as a whole? I'll let you think about what Congress might want. We know what our rules require. That is, to the extent that such considerations are or become a material part of a company's compensation policies or decisions, a company would be required to discuss them as part of its CD&A."
- "... I expect that current market events are already affecting many companies' compensation decisions and thus should be affecting the drafting of their upcoming CD&A's. Regardless of whether your company participates in the TARP and consequently finds itself having to make material new disclosures, you should not merely be marking up last year's disclosure. Instead, you should be carefully considering if and how recent economic and financial events affect your company's compensation program. For example, have you modified outstanding awards or plans, or implemented new ones? Have you reconsidered the structure of your program, or the relative weighting of various compensation elements? Have you waived any performance conditions, or set new ones using different standards? Have you changed your processes and procedures for determining executive and director pay, triggering disclosure under Item 407? These questions and more should be addressed as you consider disclosure for 2008."

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