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Interim Final Rule on TARP Standards for Compensation and Corporate Governance

- **June 15, 2009 Effective Date**
- **New Compensation Restrictions Imposed**
- **Appointment of Special Master to Review and Approve Certain compensation Amounts and Practices**

On June 10, 2009, the U.S. Treasury Department issued much-anticipated guidance on compensation and corporate governance standards applicable to entities receiving financial assistance under the Troubled Assets Relief Program ("TARP"). The guidance is set forth in an interim final rule promulgated by the Treasury (the "Interim Final Rule") as required by the Emergency Economic Stabilization Act of 2008 ("EESA"), as amended by the American Recovery and Reinvestment Act of 2009 ("ARRA"). The Interim Final Rule provides guidance necessary to implement the restrictions imposed by ARRA in addition to establishing several new standards for compensation practices pursuant to authority granted under ARRA.

The Interim Final Rule is highly technical and raises numerous interpretive issues. This memorandum summarizes certain highlights of the Interim Final Rule, provides some background information relating to the context within which the Interim Final Rule was issued, and suggests certain next steps for affected entities. Companies not currently subject to ARRA and the Interim Final Rule will be well-served by gaining an understanding of the standards they impose, as advisors in the compensation field expect many of these standards to migrate into the regulatory and legislative framework applicable to companies outside of the financial services and banking industries.

Overview of the Interim Final Rule

The Interim Final Rule provides guidance implementing compensation and corporate governance standards required by ARRA and imposes new standards. With respect to the implementation of ARRA standards, the most notable aspects of the guidance are:

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(1) an expansion of prohibited golden parachute payments to include payments due upon a change in control, whether or not employment is terminated, (2) an expansion of the entities that may be subject to the standards to those related by 50% common ownership, by vote or value, to the entity receiving financial assistance from Treasury (an increase from an 80% common ownership test in place under prior regulations applicable to participants in the TARP), thus expanding the individuals whose compensation must be analyzed to determine whether it must be restricted under the Interim Final Rule, (3) the delegation to a Special Master for TARP Executive Compensation (the “Special Master”) (discussed in more detail below) of the duty to undertake the review required by ARRA of compensation paid by any TARP recipient while Treasury financial assistance was outstanding but prior to the adoption of ARRA, (4) confirmation that ARRA’s imposition of restrictions on compensation to “highly compensated employees” includes any employee, not just officers or executives with policy and administrative functions (thereby reaching investment bankers and traders), (5) an expansion of certification and disclosure requirements for compensation committees and principal executive and financial officers with respect to compliance with various aspects of ARRA and the Interim Final Rule, (6) the expansion of ARRA’s permitted bonuses to include restricted stock units and other phantom arrangements based on the performance of a business unit or division, and (7) a requirement that all employee compensation plans (not only those used to compensate top executive officers or the most highly compensated employees) be reviewed for their potential to incentivize employees to take risks that could harm the institution.

In addition to the standards required under ARRA, the Interim Final Rule imposes the following new standards: (1) a prohibition of all types of tax gross-ups to senior executive officers and the 20 most highly compensated employees of TARP recipients, (2) enhanced disclosure of perquisites in excess of \$25,000, (3) disclosure of the use of compensation consultants, and (4) a requirement that the Special Master review and approve certain compensation amounts and structures at institutions receiving “exceptional assistance” under the TARP.

Special Master. As indicated above, the Interim Final Rule establishes the position of the Special Master and grants him broad authority to interpret ARRA, the Interim Final Rule, and any other applicable guidance. The Special Master must oversee and approve compensation amounts and structures for the senior executive officers and the 20 next most highly compensated employees of the entities receiving “exceptional assistance” under the TARP (currently AIG, Citigroup, Chrysler, Chrysler Credit, GM, GMAC, and Bank of America) and the compensation structures for any employee who is an executive officer or one of the 100 other most highly compensated employees at these entities. The Interim Final Rule sets forth principles the Special Master must consider when evaluating these compensation amounts and structures and when reviewing the pre-ARRA compensation referred to above. The authorities and obligations of the Special Master are described in more detail below. Treasury has appointed Kenneth Feinberg to serve as the Special Master.¹

The standards set out in the Interim Final Rule will generally apply while any right or requirement to repay financial assistance under TARP remains outstanding, except if the federal government only holds warrants to purchase a TARP recipient’s common stock. For entities receiving

¹ Kenneth Feinberg previously served as the Special Master of the September 11th Victim Compensation Fund and had responsibility for developing and interpreting the regulations governing, and administering all aspects of, the fund, including approving applications for compensatory relief and determining appropriate compensation for selected applicants.

financial assistance that never have any right or requirement to repay financial assistance (as discussed below), the Interim Final Rule imposes a more limited set of requirements that will apply until the government's authority to provide financing under TARP expires (until December 31, 2010, unless extended to December 31, 2011).

The Interim Final Rule is written in question-and-answer format. Treasury has requested comments on the Interim Final Rule within 60 days of publication. Additional guidance or clarification may be forthcoming in response to any comments.

Related Initiatives

On the same day the Interim Final Rule was released, Treasury Secretary Timothy Geithner issued a statement setting forth compensation principles to serve as a starting point for consideration of compensation reform and announcing support for legislation that would require annual non-binding "say-on-pay" shareholder votes and impose stricter compensation committee independence standards. Securities and Exchange Commission Chairwoman Mary Schapiro also issued a statement on executive compensation reiterating the SEC's intention to enhance executive compensation disclosure requirements, in particular to address how a company's compensation structure may be related to its risk structure. These statements are not the subject of this memorandum, but for a more detailed discussion of them, please refer to our client alert "*New Principles and Proposals on Executive Compensation Likely to Serve as the Basis for New Requirements for all U.S. Public Companies*" released on June 12, 2009. A legislative and regulatory regime based on Secretary Geithner's principles would likely allow companies to retain flexibility to set compensation at levels necessary to retain talent, but legislative or regulatory imposition of hard compensation caps and rigid rules like certain of those in the Interim Final Rule may make their way into a broad-based future legislative or regulatory framework, so all companies should keep their eye on these developments.

Effective Date

The requirements under the Interim Final Rule with respect to ARRA's provisions (other than those addressing "say-on-pay" and withdrawal from the TARP) took effect on June 15, 2009, when the Interim Final Rule was published in the Federal Register. These requirements supersede prior guidance only to the extent that prior guidance is inconsistent with them, and such inconsistent prior guidance is superseded only as of June 15, not before.² TARP

² The preamble to the Interim Final Rule provides that the rule "consolidates all of the executive-compensation-related provisions that are specifically directed at TARP recipients into a single rule (superseding all prior rules and guidance)." The preamble expressly provides that the superseded prior guidance includes the interim final rule issued by Treasury on October 20, 2008 under Section 111 of EESA, applicable to participants in Treasury's Capital Purchase Program (the "CPP"), Treasury Notice 2008-PSSF1 (addressing compensation standards applicable to systemically significant failing institutions), and Treasury Notice 2008-TAAP (addressing compensation standards applicable to entities selling troubled assets in auction programs), and that this guidance was in effect until June 15. The preamble states that the Interim Final Rule also supersedes Treasury's executive compensation guidance issued on February 4, 2009 and I.R.S. Notice 2008-94 (addressing certain tax provisions in Section 302 of EESA, which amended Internal Revenue Code Sections 162(m) and 280G). (The preamble to the Interim Final Rule points out that the January 16, 2009 amendments to the October 2008 interim final rule were returned from the Federal Register and never published and clarifies that the amendments will never be – and therefore never were – effective.)

recipients' contractual commitments in place before June 15 remain in effect if not inconsistent with ARRA or the Interim Final Rule.

Impact on Specific Compensation Items. The Interim Final Rule's restrictions related to the accrual and payment of bonuses, incentive compensation, and retention awards do not apply to amounts paid or accrued before June 15 or to amounts required to be paid pursuant to a written employment contract executed on or before February 11, 2009.³ Also, the Interim Final Rule's expanded prohibition on golden parachute payments will not apply to amounts paid before June 15. However, the Special Master may determine to review these compensation items and seek reimbursement to Treasury or the employer where appropriate.

Entities Covered by the Standards

ARRA and Interim Final Rule standards apply to all entities that have received or that hold a commitment to receive financial assistance under the TARP. Financial assistance is defined to include direct financial transactions between Treasury and private sector participants in programs under the TARP.⁴

Entities selling preferred stock to Treasury through the CPP and the entities listed above that have received "exceptional assistance" from Treasury are subject to the rules. An example in the Interim Final Rule provides that entities posting collateral to and receiving a loan from the Federal Reserve special purpose vehicle under the Term Asset Backed Security Loan Facility are not subject to the rules. Another example provides that partnerships established for the purpose of participating in the Public Private Investment Program (the "PPIP") will be subject to the rules, but other entities, such as investors, general partners, and investment advisors, will not be subject to the rules if they do not have a controlling interest in the partnership.

Certain requirements in the Interim Final Rule apply on a more limited basis or during a more limited period of time with respect to entities that, under applicable financial instruments and related agreements, never have any right or obligation to repay financial assistance received from Treasury, through the repayment of a debt obligation or the redemption or repurchase of an equity security, which does not include warrants to purchase common stock. Partnerships formed for the purpose of participating in the PPIP may be considered not to have any such right or obligation, depending on the specific PPIP program in which the partnerships participate, the final terms of such program, and possibly also the structure of the investment.⁵

³ If bonuses, incentive compensation, and retention awards relate to service periods beginning before and ending after June 15, amounts may be reduced to reflect the period after June 15. The post-June 15 amounts may be paid only when permitted under the standards in the Interim Final Rule.

⁴ Specifically, financial assistance is defined as any funds or fund commitment provided through the purchase of troubled assets under authority granted to Treasury under Section 101 of EESA or the insurance of troubled assets under the authority granted to Treasury under Section 102 of EESA, but does not include any loan modification under Sections 101 and 109 of EESA.

⁵ Entities selling securities backed by Small Business Administration-guaranteed loans to Treasury through the Consumer and Business Lending initiative, and providing warrants to Treasury for the purchase of common stock of

The Interim Final Rule generally applies until the last date upon which any such right or obligation to repay financial assistance remains outstanding. This means the standards in the Interim Final Rule will generally not apply to entities that sold preferred shares to Treasury under the CPP when those entities buy back those shares, even if warrants held by Treasury remain outstanding. The rule is not entirely clear on this point, however, as it also indicates that restrictions will apply to some extent if the federal government holds common stock of the TARP recipient, which could occur if the government becomes the owner of the stock by exercising warrants, even if the TARP recipient had previously fully repaid its obligations. It is not clear whether this was intended.

Notwithstanding the general rule that the standards in the Interim Final Rule cease to apply when financial assistance to Treasury is repaid, certain requirements appear intended to remain in effect even after the assistance is repaid, at least as applied to the period during which a TARP recipient was subject to the Interim Final Rule. Examples of these requirements are certification requirements (by the compensation committee, principal executive officer, and principal financial officer) evidencing compliance with the Interim Final Rule, and the new perquisite and compensation consultant disclosure requirements.

Affiliates of TARP Recipients. As was the case under the CPP regulations that were superseded by the Interim Final Rule, TARP recipients will include the entity receiving the financial assistance from Treasury and its affiliates that would be treated as a single employer with that entity based on the rules of Internal Revenue Code Sections 414(b) and 414(c), disregarding the rules for brother-sister and combined groups. In a departure from the prior CPP regulations, however, common ownership (by vote or value) will be tested based on a 50% test, rather than the 80% test in those Code sections and in the CPP regulations.⁶ This will potentially expand the group of executives and employees whose duties and compensation must be analyzed to determine whether they are senior executive officers or highly compensated employees subject to the restrictions. The methods for determining which officers and employees are covered are discussed in more detail below.

Effect of Acquisitions. An entity that acquires a TARP recipient and is not previously related to the TARP recipient will not become subject to the compensation standards and restrictions in ARRA and the Interim Final Rule merely because of the acquisition, even if the acquirer would have been considered a TARP recipient (because related by 50% common ownership) if the TARP funds were first received after the acquisition. If, after the acquisition, the acquirer is not subject to ARRA and Interim Final Rule standards, neither its nor the target's employees will be subject to the standards. Under an anti-abuse rule, if the primary purpose of a transaction is to evade the standards, then the standards will apply.

the entities, do not have any repurchase right or obligation to Treasury, so the Interim Final Rule should also expire earlier in these cases.

⁶ Sections 414(b) and 414(c) include the same rules used to determine so-called "controlled group" liability under Title IV of the Employee Retirement Income Security Act of 1974 and to test qualified retirement plan anti-discrimination and coverage rules.

Executive Officers and Employees Covered by the Standards

The compensation restrictions in the Interim Final Rule generally apply to the senior executive officers (determined under SEC executive compensation disclosure rules for determining named executive officers under Item 402(a) of Regulation S-K)⁷ and an additional group of up to 20 of the next most “highly compensated employees,” with the actual number depending on the amount of financial assistance received under the TARP. Unlike under current SEC disclosure rules and the prior regulations applicable to CPP participants, employees (e.g. investment bankers, fund managers, and other highly compensated employees) and not just executive officers can be subject to the restrictions. In general, partners of partnerships and members of limited liability companies will not be treated as employees, subject to an anti-abuse rule and a rule disregarding personal service corporation and similar entities when analyzing whether a person is an employee.

The senior executive officers for a year are the “named executive officers” who are employees and are identified in the TARP recipient’s annual report on Form 10-K or annual meeting proxy statement for that year (reporting the officers’ compensation for the immediately preceding year).

The “most highly compensated employees” are determined based on the employee’s prior year compensation (determined under SEC executive compensation disclosure rules for determining “total compensation” of named executive officers, without regard to whether the compensation is includible in the employee’s gross income for federal income tax purposes)⁸ and applies only to employees employed on the first day of the fiscal year. Former employees are only included if it is reasonably anticipated that they will return to work during the fiscal year. The determination as to who is a senior executive officer or highly compensated employee must be made each year, and there is no rule that once an officer or employee is covered by the rules he or she is always covered while the employer is a TARP recipient.

Even before the annual identification of the senior executive officers, the Interim Final Rule requires that the TARP recipient ensure that a potential senior executive officer or most highly compensated employee comply with the applicable executive compensation and corporate governance standards.

Private company TARP recipients must identify their senior executive officers and highly compensated employees based on the same principles as though they were a public company.

Treasury has invited comment on the issue of whether the method for determining highly compensated employees based on prior year’s compensation will result in TARP recipients intentionally cycling employees in and out of most highly compensated employee status in

⁷ Item 402 generally applies to the principal executive officer, principal financial officer, and the three most highly compensated executive officers other than the principal executive officer and principal financial officer. Under the Interim Final Rule, smaller reporting companies will be required to identify five senior executive officers even though only three named executive officers must be identified under the federal securities laws.

⁸ Note, the determination of the five senior executive officers for purposes of applying the limit on the deductibility of compensation in excess of \$500,000, pursuant to 162(m)(5) of the Internal Revenue Code, as added by ARRA, is based on the current year’s compensation and accordingly may apply to a group of employees that differs from the senior executive officers subject to the TARP compensation restrictions.

alternate years to guarantee years of exclusion from applicability of the rules, given that there is no overall compensation limit.

Immediate analysis of compensation levels should be undertaken by TARP recipients to determine the appropriate group of covered employees to ensure compliance with the TARP rules.

Implementation of ARRA Standards

The Interim Final Rule provides the following guidance implementing the compensation and corporate governance standards imposed under ARRA:

- *Limitation of Bonuses and Other Incentive Compensation*---Pursuant to ARRA, accrual and payment of bonuses, retention awards, and other incentive compensation to the most highly compensated employee and possibly also the senior executive officers and up to 20 of the next most highly compensated employees (with the actual number depending on the amount of financial assistance received under the TARP⁹) is prohibited, with a few exceptions discussed below.
 - *Accrual*: Whether bonuses, retention awards, and incentive compensation are accrued is determined based on facts and circumstances. An accrual may include the granting of service credit (whether toward the calculation of the benefit or any vesting requirement) or credit for the compensation received (or that would otherwise have been received) while the individual was subject to the bonus restriction. If bonus, retention, or incentive compensation awards relate to multi-year service periods during some portion of which an employee is subject to the prohibition and some portion the employee is not, the employee will not be treated as having accrued the payment during the period the employee was subject to the prohibition if the payment is reduced to reflect the portion of the service period the employee was subject to the prohibition. If the employee is subject to the prohibition when the amount is payable, the amounts may not be paid until payments to the employee are permitted, even if the accrual occurred during a time when the accrual was permitted.

⁹ Under ARRA and the Interim Final Rule, the individuals subject to the limitation are as follows:

<u>Amount of Financial Assistance</u>	<u>Individuals Covered</u>
Less than \$25 million	The most highly compensated employee
At least \$25 million but less than \$250 million	Five most highly compensated employees
At least \$250 million but less than \$500 million	Senior executive officers and the next 10 most highly compensated employees
\$500 million or more	Senior executive officers and 20 most highly compensated employees

If any additional financial assistance would result in additional employees being subject to the bonus prohibition, the prohibition applicable to the additional employees will not apply until the following fiscal year.

- Definitions of Bonuses, Retention Awards, Incentive Compensation:* Whether a payment is a bonus, retention award, or other incentive compensation is determined based on all facts and circumstances. A payment may be subject to the limitation regardless of how the employer and employee characterize it and may include forgiveness of a loan or other amount otherwise payable by the employee to the employer. Under the Interim Final Rule, a “bonus” is very broadly defined as any payment in addition to any amount payable for services performed by an employee at a regular periodic rate and may include contributions to non-qualified deferred compensation plans regardless of when actual payments are made under the plans. (A bonus may also be a retention award or incentive compensation.) A retention award is defined as a payment that is not payable periodically to an employee for services performed at a periodic rate, is contingent on completion of future service or of a specific project or activity of the TARP recipient and is generally not based on performance or business activities or value of the TARP recipient. Retention awards include signing bonuses and “make-whole” payments to compensate new employees for a forfeited bonus from a prior employer, ordinary course accruals under nonqualified deferred compensation qualified plans will not be treated as retention awards. Incentive compensation is defined as compensation provided under an incentive plan, as defined for annual federal proxy disclosure purposes, in Item 402(a) of Regulation S-K, and includes any plan providing for equity based compensation.
- Exception for Long-Term Stock Grants:* An exception to the prohibition on paying or accruing bonuses, retention awards, or incentive compensation is that amounts up to one third of the employee’s total compensation¹⁰ may be payable in the form of restricted stock, restricted stock units (settled in stock or cash), or phantom equity arrangements based on the performance of a business unit or division. For purposes of determining whether a payment is more than one-third of an individual’s annual compensation, current (rather than prior) year compensation is used,¹¹ and the total grant date fair market value of equity compensation is used to measure value; the value is not amortized. The Interim Final Rule does not specify how total fair market value on the grant date is measured (for example, by referring to Statement of Financial Accounting Standards No. 123R or to some other method). In addition, the restricted stock, restricted stock unit, or phantom equity arrangement may not be transferable at a rate sooner than 25% for each 25% of financial assistance repaid, except that a

¹⁰ Total compensation for the purpose of this exception is determined under SEC compensation disclosure rules for determining total compensation (Item 402(a) of Regulation S-K) except that equity based compensation granted in years prior 2009 will be excluded from the calculation and the total fair market value of any such awards will be reflected in annual compensation only in the year of grant.

¹¹ In contrast, recall that prior year compensation is used to determine who is a highly compensated employee.

portion equal to the amount required to pay income taxes may be transferable sooner and will not be counted towards these percentages. The employee must be required to forfeit the award if the employee does not continue performing substantial services for the TARP recipient for at least two years from the date of grant, other than due to the employee's death, disability, or a change in control event. Additional restrictions, such as longer service periods and additional performance criteria, may be imposed. The Interim Final Rule does provide that a TARP recipient may be paid their salary or another permissible payment in stock or a restricted stock unit or phantom unit, so long as the stock is not subject to a substantial risk of forfeiture (as defined in the Internal Revenue Code Section 83 regulations) or other future period of required services, the amount of the payment is determinable as a dollar amount, and the amount of stock accrued under the salary or other permissible payment would be paid in cash.¹²

- *Exception for Bonuses under Grandfathered Contracts:* A second exception to the prohibition is that any bonus, retention, and incentive payments required pursuant to any written contract under which an employee had a legally binding right to the payment as of February 11, 2009 will be permitted. The payment may only be made in accordance with the terms of the contract as of February 11. Any amendment to increase the amount payable, accelerate vesting, or otherwise materially enhance the benefit available to the employee under the contract will not be treated as one providing for permitted, grandfathered payments.
- *Exception for Commissions:* Another exception is that certain commission arrangements are permitted. Generally, programs in effect prior to February 17, 2009 that provide payments for sales to, and investment management services for unrelated third parties, such as are typically seen in broker-dealer insurance, and investment advisory (i.e. assets-under-management-based commissions) divisions of TARP recipients will be permitted.¹³ Investment banking fees, proprietary trading, fees from sales to affiliates, and commission programs adopted by a TARP recipient after February 17, 2009 will not be permitted.
- *Anti-Abuse Rule:* Under an anti-abuse rule, any payment in a year following the end of a year when the bonus restriction was in place will

¹² Restricted stock units that are not subject to a substantial risk of forfeiture would normally be considered nonqualified deferred compensation subject to Internal Revenue Code Section 409A. Under the Interim Final Rule, however, these units will not be subject to Internal Revenue Code Section 409A if the employer provides that the units are settled on the later of the expiration of the Section 409A short-term deferral period and the date when the employer is not participating in the TARP.

¹³ These commission arrangements will be taken into account when determining who is one of the "most highly compensated employees."

be recharacterized as a prohibited payment if designed to make an employee whole for the lost bonus opportunity during the restricted period. The preamble to the Interim Final Rule provides that non-payment of bonus, retention, and incentive compensation payments to comply with the Interim Final Rule will generally not be treated as impermissible deferral elections under, or as turning short-term deferrals into nonqualified deferred compensation subject to, Internal Revenue Code Section 409A so long as payments are delayed until the employee is no longer subject to the prohibition and are made promptly following the first date when payment could be made without violating the terms of the agreement between the TARP recipient and Treasury and in accordance with the Interim Final Rule.

- *Prohibition on Parachute Payments*---In addition to the prohibition on severance payments to senior executive officers and to any of the five next most highly compensated employees upon termination of employment,¹⁴ the Interim Final Rule expands the prohibition to payments due upon a change in control, even if no termination of employment occurs (i.e., “single trigger” payments). However, the rules permit payments from qualified retirement plans and similar foreign plans, payments due to an employee’s death or disability, and severance payments required by law. Under ARRA, payment of accrued benefits are permitted, so it is likely that any vested benefits payable upon termination or a change in control can be provided. Parachute payments will be deemed paid at the time of the employee’s departure regardless of the actual payment date, so any attempt to avoid the payment restrictions by delaying such payments to the period following the repayment of financial assistance under the TARP will not be effective.
- *Clawback on Incentive Compensation*---Pursuant to ARRA, TARP recipients must adopt a policy that bonuses, retention awards, and other incentive compensation paid to a senior executive officer and any of the 20 next most highly compensated employees are subject to clawback if the payment was based on materially inaccurate financial statements or any other materially inaccurate performance criteria. The test for material inaccuracy is based on all facts and circumstances, but any financial statements or performance metric criteria will be treated as materially inaccurate with respect to any employee who knowingly engaged in providing or failing to timely correct inaccurate information relating to those statements or criteria.¹⁵ TARP recipients must enforce the provisions of their clawback policy, unless doing so would be unreasonable (for example, if the cost of enforcement outweighed the benefit of doing so).

¹⁴ Under ARRA there is no longer any exception for any amount of a golden parachute payment as there had been under the previous regulations applicable to institutions participating in the CPP.

¹⁵ As noted in the prior CPP regulations, the TARP-required clawback policy is broader than the current Sarbanes-Oxley clawback requirement for public companies, which is limited to clawbacks of payments in the prior 12 months to the chief executive officer and chief financial officer as a result of material non-compliance with financial reporting requirements that triggers a financial restatement, and clawbacks of any profit from sales of company securities during that period.

- Policy on Luxury Expenditures*---The boards of directors of TARP recipients must adopt a written, company-wide policy that is reasonably designed to eliminate excessive or luxury expenditures. Excessive or luxury expenditures are defined as excessive expenditures on entertainment or events, office and facility renovations, aviation or other transportation services or other similar items or events, to the extent such expenditures are not reasonable expenditures for staff development, reasonable performance incentives, or other similar reasonable measures conducted in the normal course of the TARP recipient's business operations. The policy must include written standards addressing these categories of expenses, which must identify prohibited expenditures and expenditures for which prior approval must be sought, provide reasonable procedures for obtaining approvals, require prompt internal reporting of policy violations, and mandate accountability for adherence to the policy. The policy must also require that the principal executive officer and principal financial officer certify that the approval of any expenditure that requires the prior approval of any senior executive officer or any executive officer with substantially similar level of responsibility or board member was properly obtained. The policy must be adopted within 90 days after the later of June 15, 2009 and the closing date of the agreement between Treasury and the TARP recipient and must be posted on the TARP recipient's website and filed with Treasury and the TARP recipient's primary regulatory agency.
- Compensation Committee Review of Compensation and Expanded Certifications*---Pursuant to the Interim Final Rule, TARP recipients are required to establish and maintain a compensation committee comprised of independent board members. The committee must be established within 90 days after the later of June 15, 2009 and the closing date of the agreement between the TARP recipient and Treasury. This committee must conduct semi-annual reviews of all senior executive officer and employee compensation plans to assess any excessive risks or manipulation of earnings encouraged by such plans.¹⁶ Specifically, the committee must discuss, evaluate, and review with senior risk officers (1) the senior executive officer compensation plans to ensure that such plans do not encourage the officers to take unnecessary and excessive risks that threaten the value of the TARP recipient, and (2) employee compensation plans in light of the risks posed to the TARP recipient by such plans and how to limit such risks. The committee must also discuss, evaluate, and review employee compensation plans to ensure that the plans do not encourage the manipulation of reported earnings to enhance the compensation of any employees of the TARP recipient. At least once per year, the committee is required to provide a detailed narrative description of its compensation review and certify completion of the review. The description must address how the senior executive officer compensation plans do not encourage the officers to take unnecessary and excessive risks that threaten the value of the TARP recipient, including how the plans do not encourage behavior focused on short-term results rather than long-term value creation; the risks posed by employee compensation plans and how they were limited, including how these employee compensation plans do not encourage behavior focused on short-term results rather than long-

¹⁶ This function may be delegated to the board of directors for non-public TARP recipients who have received less than \$25 million of assistance.

term value creation; and how the TARP recipient has ensured that the employee compensation plans do not encourage the manipulation of reported earnings to enhance employee compensation.¹⁷

- *Principal Officer Certifications*---In addition, the principal executive officer and principal financial officer will be required to annually certify that the compensation review and analysis was undertaken; the rules and restrictions imposed under the Interim Final Rule have been complied with; and that appropriate measures are in place to promote continued compliance. The Interim Final Rule describes 15 separate detailed items the executives must certify as true (model certifications are included in the Interim Final Rule), and any false statements may give rise to criminal or civil penalty. The certification must also include a list of the senior executive officers and the next 20 most highly compensated employees.

Even though the Interim Final Rule does not address ARRA's requirement that TARP recipients comply with Internal Revenue Code Section 162(m)(5) (which reduced the maximum amount of compensation that may be deducted in any taxable year by a TARP recipient in respect of its chief executive officer, chief financial officer, and its other three highest compensated employees and eliminates any performance based compensation exception (and certain other exceptions) that would otherwise be available under Section 162(m) to non-TARP companies), according to the preamble to the rule, Treasury anticipates requiring this condition in future agreements to provide TARP assistance and considers TARP recipients to be bound by the rule now under current contracts with Treasury.

Adoption of New Standards

- *Prohibitions on Tax Gross-Ups*---TARP recipients are prohibited from providing senior executive officers and the 20 next most highly compensated employees with any "gross-up" payment of any kind, including for taxes incurred on any severance or change in control payment or any perquisite or company-provided benefit. The prohibition covers "informal" gross-ups, which is likely intended to prevent increases in some forms of compensation to make the employee whole for taxes and effectively provide a gross-up on another form of compensation.
- *Mandated Disclosure of Compensation Consultants and Services Provided.* Under the Interim Final Rule, TARP recipients must disclose any non-compensation related services provided by compensation consultants to TARP recipients (for the purposes of revealing any potential conflicts of interest) and describe the use of "benchmarking" procedures or comparisons employed by the compensation consultant to identify certain percentile levels of compensation. Because TARP recipients include entities with 50% common ownership (by vote or value) with the entity that actually received the financial assistance from Treasury, this disclosure could be extensive for entities with a significant number of parents and subsidiaries,

¹⁷ The compensation committee of a public entity must provide these certifications and disclosures in the Compensation Committee Report (as required pursuant to Item 407(e) of Regulation S-K under federal securities laws) and to Treasury, and the compensation committee of a private company must provide such certifications and disclosure to its primary regulatory agency and to Treasury, in each case, within 120 days of the completion of each fiscal year during which they are continuing to receive TARP assistance.

many of which are using large consulting firms that provide a variety of services to clients beyond just executive compensation services. Such disclosures must relate to the entity's use of the compensation consultant over the past three years and must be provided to the entity's primary regulatory agency and to Treasury within 120 days of the completion of each fiscal year during which the entity is continuing to receive TARP assistance. These disclosure requirements go beyond the existing federal securities regulations that require only that public companies identify compensation consultants and their role in setting executive and director compensation, though it is not entirely clear what specific information Treasury is seeking, what specific issues relating to the use of consultants it considers problematic, and what it intends to achieve by requiring disclosure. These expanded disclosure requirements may signal a new direction with respect to disclosures related to compensation consultants in anticipated SEC regulations.

- *Additional Perquisite Disclosure*---TARP recipients must provide additional disclosure of perquisites for all covered employees in excess of \$25,000, including a narrative description of, and justification for such perquisites. This disclosure requirement is more extensive than the current SEC rules for annual proxy statement disclosure of perquisites for public companies.

The Role of the Special Master

The Interim Final Rule establishes the position of the Special Master who is appointed by and serves at the pleasure of the Treasury Secretary. Under the rule, the Special Master has been given broad interpretive powers, the mandate to approve compensation amounts and structures for certain employees of entities receiving exceptional assistance under TARP, and the power to review compensation paid while Treasury financial assistance was outstanding but before ARRA was passed into law. The Special Master will also have the power to issue advisory opinions and to exercise other authority granted by the Treasury Secretary from time to time.

Interpretive Authority---The Special Master has broad powers to interpret and apply EESA, the Interim Final Rule, and contractual arrangements between TARP recipients and the federal government.

Review and Approval of Compensation Payments and Structures for Employees of Entities Receiving Exceptional Financial Assistance---With respect to TARP recipients who are receiving exceptional financial assistance¹⁸, the Special Master also has authority and is required to approve the compensation structure and the amounts payable to the senior executive officers and 20 next most highly compensated employees, and to approve the compensation structure (but not amounts payable) for employees who are either executive officers or one of the 100 most highly compensated employees who are not subject to ARRA's and the Interim Final Rule's bonus limitation. In determining whether to approve these compensation amounts or structures,

¹⁸ The Interim Final Rule defines exceptional financial assistance as any financial assistance provided under the Programs for Systematically Significant Failing Institutions, the Targeted Investment Program, the Automotive Industry Financing Program, and any new program designated by the Secretary as providing exceptional financial assistance.

the Special Master must take into account payments made before June 15 or payments made under employment agreements in effect on February 11.¹⁹

With respect to the employees whose compensation structure only (but not compensation amounts) must be approved by the Special Master, the Interim Final Rule provides a “safe harbor” total annual compensation amount under which the compensation structure will automatically be deemed to meet the requirements of the Interim Final Rule and ARRA, and no prior approval by the Special Master will be required. This amount is \$500,000 plus an unlimited amount of compensation structured as described above in the “Exception for Long-Term Stock Grants” section of this memorandum.²⁰ “Total annual compensation” for this purpose will include (1) any change in actuarial present value of pension benefits and above market earnings on deferred compensation and (2) equity-based compensation granted in fiscal years ending after June 15, 2009 (provided, that, such equity-based compensation is taken into account only in the year of grant and based on the total fair market value on the grant date).

Under the Interim Final Rule, TARP recipients receiving exceptional financial assistance will be required to submit their initial requests for approval of compensation structures by the Special Master within 60 days (for senior executive officers and the 20 next most highly compensated employees) and 120 days (for other executive officers and employees) following June 15, 2009. Subsequent requests for approval must be made when a previously approved compensation structure is materially modified. All final determinations of the Special Master, following a 30-day window for submission for reconsideration, are binding on the TARP recipient and are not appealable. Any information submitted to the Special Master as well as any determinations issued by him are subject to disclosure under the Freedom of Information Act.

Review of Prior Payments---The Special Master has the power and is required to identify and review bonus, retention, and other payments made to senior executive officers and the 20 next most highly compensated employees prior to February 17, 2009, to determine if they are inconsistent with the purposes of ARRA or the Interim Final Rule or are otherwise contrary to the public interest. The Special Master has authority to negotiate for reimbursement to either the TARP recipient or to the Federal government in those instances. Treasury has specifically requested comments and proposals for procedures and the terms by which any such reimbursement should occur.

The Special Master’s review of compensation paid prior to February 17, 2009 is guided by principles established under the Interim Final Rule, which are whether: (1) compensation rewards excessive risk taking, (2) the structure facilitates competitiveness in its ability to retain and recruit talented employees and increase the likelihood of repayment of TARP assistance, (3) the components of compensation are appropriately allocated based on the specific role of the employee, (4) the appropriate portion of compensation is performance-based over a relevant

¹⁹ The Special Master may also take these payments into account in issuing any advisory opinion under the Interim Final Rule (discussed below).

²⁰ The section of the preamble that addresses the “safe harbor” amount has broad language that any compensation up to \$500,000, including bonuses, retention awards, and incentive compensation, is permitted. However, the Interim Final Rule itself requires that the compensation paid up to \$500,000 also comply with the prohibition on bonuses, retention awards, and incentive compensation applicable to senior executive officers.

period, (5) the structure is comparable and consistent with similar roles at similar entities, and (6) the employee contributed to the value of the firm.

Advisory Opinion---The Special Master can render non-binding advisory opinions as to whether a compensation structure or payment is or will be consistent with legislative requirements and goals. Advisory opinions can be initiated at the request of any TARP recipient (it is not limited to TARP recipients who receive exceptional assistance), a TARP recipient employee, or upon the Special Master's own initiative. Upon rendering any adverse advisory opinion, the Special Master is empowered to negotiate with the TARP recipient and the relevant employee for reimbursement to either the TARP recipient or the federal government.

Next Steps

TARP Recipients---The Interim Final Rule will require significant time to implement, and TARP recipients should immediately begin to: (1) identify covered employees, (2) analyze and restructure compensation arrangements if necessary to comply with the compensation standards and restrictions (for example, by eliminating tax gross-ups and adding clawback provisions), (3) adopt a policy on luxury expenditures, (4) identify prohibited accruals and payments and take steps to ensure that they are not made, (5) implement administrative measures to ensure compliance with the compensation standards and restrictions including, required disclosures and certifications, and (6) solely for TARP recipients receiving exceptional assistance, prepare compensation arrangements for review by the Special Master. TARP recipients should also pay attention to releases and additional guidance or clarification that may be issued by Treasury and the SEC.

Public Companies that are not TARP recipients---The Interim Final Rule, Secretary Geithner's statement setting forth compensation principles and announcement of support for say-on-pay and compensation committee independence legislation, and SEC Chairwoman Schapiro's statement that reiterated the SEC's intention to enhance executive compensation disclosure requirements, each shed light on the possible regulatory direction of executive compensation rules for companies generally. The current direction appears oriented towards the goal of enhancing compensation disclosure requirements, involving shareholders in the process of establishing and reviewing compensation practices, and strengthening compensation committee and consultant independence.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues discussed in this memorandum may be addressed to any of the following:

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