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Emerging Themes in Compensation Regulation

On October 22, 2009, the Special Master for TARP Executive Compensation released seven Determination Memoranda (the “Special Master Rulings”) addressing the limits on compensation payable to top executives at TARP entities that received “exceptional assistance.”¹ On the same day, the Federal Reserve Board (the “Fed”) released proposed guidance (the “Fed Guidance”) on incentive pay at the financial organizations that it regulates.² Both the Special Master Rulings and the Fed Guidance build upon several trends related to executive pay that have come more sharply into focus as a result of the financial crisis.

Not surprisingly, the Special Master Rulings and the Fed Guidance parallel some bills introduced in Congress and regulations proposed by Treasury and the Securities and Exchange Commission (the “SEC”) addressing executive pay and the manner in which it is determined.³ While the Special Master Rulings and the Fed Release apply only to financial organizations, they provide insight into the direction that Congress and federal regulators may take in regulating executive pay and the process by which pay decisions are made and disclosed to investors. The following discussion does not summarize the Fed Guidance or the outcome of the Special Master Rulings in detail, but rather attempts to identify common themes in

the guidance and rulings that may be harbingers of broader regulatory initiatives and prevailing pay practices.

Recurring Topics in Compensation Regulation

Pay Levels Reduced, But No Hard Caps

The Special Master Rulings generally decrease the overall pay levels for top executives, but do not cap the potential incentive compensation that they can earn. Instead, the Special Master reinforces the idea that total compensation should be reasonably benchmarked to the market and takes the position that, for entities receiving exceptional TARP assistance, total compensation for

¹ For more background and detail on the compensation regulations under the Troubled Asset Relief Program (“TARP”), you may refer to the following Shearman & Sterling publications: “Treasury Releases Executive Compensation Regulations for TARP Recipients,” *available at* www.shearman.com/treasury-releases-executive-compensation-regulations-for-tarp-recipients; Executive Compensation Restrictions on TARP Recipients Under the Economic Stimulus Bill,” *available at* www.shearman.com/eceb_021809; “Executive Compensation Under the Emergency Economic Stabilization Act of 2008,” *available at* www.shearman.com/eceb_100308; and “Executive Compensation Under the Emergency Economic Stabilization Act of 2008: A First Take on the Guidance,” *available at* www.shearman.com/eceb_102108.

² The Fed Guidance covers entities regulated by the Fed, which include U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company subsidiary in the United States (collectively, “Bank Organizations”).

³ See, e.g., Shareholder Approval of Executive Compensation of TARP Recipients, 74 Fed. Reg. 32474 (proposed July 8, 2009) (to be codified at 17 C.F.R. pt. 240), *available at* <http://www.sec.gov/rules/proposed/2009/34-60218fr.pdf>; Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35076 (proposed July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270 and 274), *available at* <http://fdsys.gpo.gov/fdsys/pkg/FR-2009-07-17/pdf/E9-16764.pdf>; The Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009); The Restoring American Financial Stability Act of 2009, Discussion Draft, 111th Cong. (2009), *available at* http://banking.senate.gov/public_files/AYO09D44.xml.pdf.

covered employees should reflect the individual's value to the entity. In addition, the rulings reallocate compensation among cash, restricted stock and long-term equity awards by reducing cash compensation and subjecting more compensation to vesting and transferability restrictions. Again, with a positive nod to benchmarking, the Special Master Rulings assert that cash salaries for entities receiving exceptional assistance should not exceed the 50th percentile of the entity's peer group level.

In contrast to the Special Master Rulings, a few preliminary proposals to cap executive pay have been introduced in Congress, but there is little indication that these proposals will become law.⁴ The Special Master's reluctance to impose caps on incentive compensation and the Special Master's reliance on market data in setting pay levels should help allay concerns about the federal government imposing limits on aggregate compensation amounts. This echoes the sentiment expressed by Chairman Mary Schapiro when she stressed that the SEC's role is not to set pay scales or cap compensation but to inform investors of how compensation impacts the risk profiles and long-term value of public companies.⁵ Consequently, future emphasis by regulators and investor groups will likely be on the allocation of compensation among short- and long-term components, the proper alignment of executive and shareholder interests, and risk management principles.

⁴ Congress and Treasury flirted with proposals that would cap pay at \$400,000 and that would place procedural hurdles to grant compensation exceeding 100 times the average salary of all employees. See e.g., Press Release, U.S. Department of the Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), available at <http://www.treasury.gov/press/releases/tg15.htm>; The Cap Executive Officer Pay Act of 2009, S. 360, 111th Cong. (2009); The Excessive Pay Shareholder Approval Act, S. 1006, 111th Cong. (2009); and The Excessive Pay Capped Deduction Act of 2009, S. 1007 111th Cong. (2009).

⁵ Press Release, SEC, Chairman Schapiro Statement on Executive Compensation (Jun. 10, 2009), available at <http://www.sec.gov/news/press/2009/2009-133.htm>.

Pay-for-Performance

The Special Master Rulings set out several guidelines for performance-based compensation paid by entities receiving exceptional assistance:

- Performance-based pay must be subject to vesting and transferability restrictions.
 - Salary delivered in the form of stock will vest automatically but must remain nontransferable for at least three years, becoming transferable one year earlier than scheduled if the entity repays all of its TARP assistance.
 - Long-term restricted stock awards may not vest unless and until the employee remains employed as of the third anniversary of the grant date.
- Long-term incentive awards must be based on objective performance metrics developed in consultation with the Special Master and should be granted only if the performance criteria are met. Long-term awards must be payable in the form of restricted stock.

After the passage of EESA and the TARP Regulations, some commentators speculated that Congress and the Treasury were attempting to move away from incentive-based compensation, particularly in light of the drastic bonus restrictions imposed by the TARP Regulations.⁶ Accordingly, TARP Recipients sought to increase base salaries and introduce "stock salary" to comply with the regulations. Now, the Special Master's statements about the importance of linking financial incentives to the overall performance of the company seem to clarify that, in fact, performance-based compensation remains an important part of overall

⁶ The compensation provisions of EESA and the TARP Regulations prohibited bonuses and incentive pay entirely, unless they adhered to strict transferability requirements (becoming transferable upon repayment of certain percentages of TARP assistance) and were limited to one-third of total compensation.

compensation – but it must be implemented in a way to account for the entity’s risk horizons and to foster long-term value creation.

The Special Master Rulings represent a notable move toward paying a larger portion of compensation in the form of un-leveraged company stock.⁷ Conspicuously absent from permitted forms of incentive-based pay are leveraged equity instruments like stock options. To date, the SEC and Treasury have declined to set rules for performance-based compensation. Nonetheless, the Special Master and Fed’s reasoning with respect to tying pay to long-term value creation and limiting risk seems consistent with principles that other regulators have favored, and we will likely find that the Special Master Rulings serve as reference points for public companies in the financial services industry and elsewhere that seek to implement performance-based compensation policies that conform to the prevailing norms for executive pay.⁸

Risk Management

The almost universal focus on the actual or perceived link between corporate pay and corporate risk is here to stay. The Fed Guidance and the Special Master Rulings require

the compensation committees to consider risks to the corporation in designing incentive compensation plans and related awards. A major driver behind the TARP regulations is the widely held belief that certain compensation structures contributed to the financial crisis by incentivizing risky behavior. The Special Master specifically states, “the regulations make clear that my compensation determinations should be made in such a way that considers whether senior executives are provided incentives to avoid taking excessive risks to receive greater amounts of compensation.”⁹ In addition, the Fed Guidance directs that incentive compensation at Fed regulated financial institutions not compromise the safety and soundness of these entities.

Both the Special Master Rulings and the Fed Guidance focus on the need for transferability restrictions on incentive pay and systematic and enforced deferrals of incentive payments. The Special Master Rulings require recipients of exceptional TARP assistance to impose strict vesting and transferability restrictions on both stock salary and long-term incentive payments, as described above. Similarly, the Fed Guidance directs Bank Organizations to consider the timeline over which risks posed by the business activities linked to incentive compensation might materialize and to use that timeline when developing vesting and transferability schedules. Deferral of payments also helps enforce clawbacks that

⁷ The increased use of stock-based compensation may lead to an unintended windfall to covered employees, who may receive stock at what might be an artificially low price, given current market conditions. The *New York Times* made this observation noting that many employees of financial institutions have seen unusually large gains in their equity grants received during the financial meltdown. Louise Story, *Windfall Seen as Banks Give Bonuses in Stock*, N.Y. TIMES, Nov. 8, 2009.

⁸ See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35076 (proposed July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270 and 274), available at <http://fdsys.gpo.gov/fdsys/pkg/FR-2009-07-17/pdf/E9-16764.pdf> (calling for enhanced disclosure on incentive compensation arrangements and their impact on the company’s risk profile). See also, Press Release, SEC, Chairman Schapiro Statement on Executive Compensation (Jun. 10, 2009), available at <http://www.sec.gov/news/press/2009/2009-133.htm> (describing the need for enhanced disclosure about a company’s overall compensation approach to inform investors about “incentive structures that rewarded short term risk taking without taking into account the potential long term effects on the company are widely believed to have contributed to the economic crisis.”)

⁹ Press Release, U.S. Department of the Treasury, Special Master for TARP Executive Compensation Kenneth R. Feinberg Testimony before the House Committee on Oversight and Government Reform (Oct. 28, 2009), available at <http://www.treas.gov/press/releases/tg334.htm>.

are required under TARP and that are highly encouraged as a general corporate governance matter.¹⁰

The Special Master Rulings and the eventual regulations that implement the Fed Guidance on risk and pay seem to be setting a baseline for many public companies beyond the financial services industry. The push to incorporate risk management into compensation practices at all public companies is reflected in the SEC's recently-released proposed amendments to the proxy disclosure rules that require all public entities to disclose compensation policies for all employees if those policies may have a material effect on the registrant's risk profile.¹¹ The interaction in different industry settings between risk and compensation, however, requires further development. As is noted in several comment letters to the SEC, disclosure in the proxy statement of the risk management analysis introduced by the TARP legislation (and upon which the SEC proposal appears to be modeled) may not add significant value to an investor's decision matrix outside of the financial services arena, and may ultimately be confusing to shareholders.¹² In addition, some letters note that addressing risk in a segregated manner outside the broader business context

makes the risk discussion less meaningful, since business risks are interwoven across all areas of the business – not just in compensation structures.¹³

Nonetheless, the concept of risk management in compensation has arisen in numerous places, including Congress, the Financial Stability Forum, and the G-20.¹⁴ In order to make it meaningful in the broader lexicon of compensation regulation, companies and their advisors will need to scrutinize the manner in which compensation practices impact the risk-taking associated with each company's business model.

Severance

Both the Fed Guidance and the Special Master Rulings are highly critical of severance payments (including golden parachutes). The Fed Guidance cautions Bank Organizations to guard against "golden parachutes" (defined as any payment or acceleration of deferred compensation on an employee's departure or a change in control) that may impact the safety and soundness of a financial organization by eliminating risk controls by accelerating payments of long-term incentives. More specifically, the Fed warns that any acceleration of performance periods, deferral schedules, or vesting and transferability schedules will negate their risk management purposes. The TARP Regulations expressly prohibit any severance to a senior executive officer or top five employee related to a departure while an entity has

¹⁰ Clawbacks are generally viewed as an important tool in compensation management, and the trend toward strong clawback policies has been on the rise at large public companies. According to Shearman & Sterling's 2009 Director and Executive Compensation Survey, in 2008, 56 of the 100 public companies surveyed publicly disclosed that they had clawback policies. This is nearly a 60% increase from the 35 companies that disclosed these policies in 2007. See Shearman & Sterling LLP, 2009 Director and Executive Compensation Survey, www.shearman.com/corporategovernance. The Survey is a trends analysis based on the proxy statements and other corporate governance documents of the 100 largest U.S. public companies, as ranked by Fortune magazine's Fortune 500 list, by revenue, for the most recently ended fiscal year, that have equity securities listed on the NYSE or NASDAQ.

¹¹ See Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35076 (proposed July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270 and 274), available at <http://fdsys.gpo.gov/fdsys/pkg/FR-2009-07-17/pdf/E9-16764.pdf>.

¹² See Letter from Arden Phillips, Chairman, Corporate and Securities Committee of the Association of Corporate Counsel, to the SEC (Sept. 15, 2009), available at <http://www.sec.gov/comments/s7-13-09/s71309-115.pdf>.

¹³ See Letter from Jeffrey Rubin, Chair of the Committee on Federal Regulation of Securities, American Bar Association, to the SEC (Oct. 16, 2009), available at <http://www.sec.gov/comments/s7-13-09/s71309-152.pdf>.

¹⁴ See, e.g., Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009) (calling for federal regulators of financial institutions to issue regulations governing risk management and incentive-based compensation); Press Release, Financial Stability Board, Financial Stability Board Issues Implementation Standards on Compensation (Sept. 25, 2009), available at http://www.financialstabilityboard.org/press/pr_090925b.pdf; G-20 Finance Ministers and Central Bank Governors, Declaration on Further Steps to Strengthen Financial System, Sept. 5, 2009, http://www.g20.org/Documents/FM_CBG_Declaration_Final.pdf.

outstanding TARP obligations, and the Special Master Rulings prohibit entities from using 2009 compensation to increase severance opportunities for covered employees.

There are also several legislative proposals currently pending that would require a shareholder vote on “golden parachute” (or change in control) payments,¹⁵ and legislative and regulatory efforts to curb severance packages are hardly new. The passage of Section 280G of the Internal Revenue Code imposed adverse personal and corporate tax consequences on certain “excessive” golden parachutes (including severance payments). The SEC’s proxy disclosure rules require public companies to disclose potential payments upon a named executive officer’s termination of employment or a change in control of the company.¹⁶ In addition, shareholder activist groups and proxy advisory firms have consistently taken severance arrangements into consideration when evaluating executive compensation programs.¹⁷

The Special Master Rulings and Fed Guidance continue this trend and suggest that severance arrangements will likely continue to be a concern for regulators and investors. They also signal that boards of directors and compensation committees will be under increased pressure to justify any decisions to enter into or renew golden parachutes.

SERPs and Perks

The Special Master Rulings take a hard line on SERPs and perks. With respect to SERPs, the Special Master repeats

in each of his rulings the striking statement that “covered employees should fund their retirements using wealth accumulated based on company performance while they are employed, rather than being guaranteed substantial retirement benefits by the company regardless of company performance during and after their tenures.”¹⁸

The Special Master’s proposed norm for SERPs is a significant departure from the government’s current approach of regulating SERP through increase public disclosure of the benefits they provide. The 2006 amendments to the SEC proxy disclosure rules require all public companies to disclose the value of all pension benefits, both tax-qualified and nonqualified, earned and accumulated each year by named executive officers.¹⁹ More recently, the SEC has renewed its efforts to require public companies to explain the rationale for SERP benefits in the compensation discussion and analysis in each year’s annual proxy statement.²⁰

With respect to perks, the Special Master Rulings similarly state that covered employees “generally should be responsible for paying personal expenses.”²¹ The case against perks has been made before by the SEC, shareholder activists, proxy advisory firms and the news media, so this position comes as no surprise. The SEC currently requires public companies to disclose

¹⁵ See, e.g., The Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009).

¹⁶ 17 C.F.R. § 229.402(j) (2009).

¹⁷ See, e.g., RiskMetrics Group, 2009 U.S. Proxy Voting Guidelines Summary, Dec. 24, 2008, available at <http://www.usfunds.com/media/files/pdfs/compliancepolicies/RMG2009SummaryGuidelinesUnitedStates.pdf>; Institutional Shareholder Services, 2008 U.S. Proxy Voting Manual (last visited Nov. 9, 2009), <http://governanceanalytics.com/content/menutop/content/subscription/usvm.html>.

¹⁸ See, e.g., Determination Memorandum from Special Master Kenneth Feinberg, to Bank of America Corporation (Oct. 22, 2009) A10, available at <http://www.treas.gov/press/releases/docs/20091022%20Bank%20of%20America%20Letter.pdf>.

¹⁹ 17 C.F.R. § 229.402(c)(2)(viii), (h) (2009).

²⁰ Proxy advisory firms have addressed SERPs in their voting guidelines, so it is possible that SERPs may come under even more pressure in say-on-pay or other shareholder proposals. See, e.g., RiskMetrics Group, 2009 U.S. Proxy Voting Guidelines Summary, Dec. 24, 2008, available at <http://www.usfunds.com/media/files/pdfs/compliancepolicies/RMG2009SummaryGuidelinesUnitedStates.pdf>.

²¹ See, e.g., Determination Memorandum from Special Master Kenneth Feinberg, to Bank of America Corporation (Oct. 22, 2009) A10, available at <http://www.treas.gov/press/releases/docs/20091022%20Bank%20of%20America%20Letter.pdf>.

perquisites.²² In addition, the TARP Regulations require a narrative disclosure of any perks exceeding \$25,000 to be provided to Treasury. Proxy advisory firms have issued “no-vote” recommendations based on their view that a company provides excessive perks.²³

In response to these criticisms, many public companies have already been limiting their use of SERPs and perquisites, and several companies disclosed in their 2009 proxy statements that they had reduced or eliminated perquisites.²⁴ The approach advocated in the Special Master Rulings is likely to accelerate this trend.

Corporate Governance

Before TARP, federal controls on compensation were mainly tied to tax incentives (or disincentives), enhanced disclosure requirements (for public companies), and independence standards for compensation committees. More recently, Congress and certain investor groups are advocating this approach by advocating non-binding shareholder votes on compensation.²⁵ The general principle underlying enhanced disclosure and say-on-pay measures is that well-informed and appropriately empowered shareholders will serve as a check on executive pay.

²² Public companies are required to list any perquisites whose value exceeds \$10,000 in a footnote to the Summary Compensation Table filed in the company's annual proxy disclosure. To the extent any of those perquisites exceeds the greater of \$25,000 or ten percent of the total value of all perquisites for the individual, the company must specifically disclose the value of that perquisite. See 17 C.F.R. § 229.402(c)(2)(ix)(4) (2009).

²³ See, e.g., RiskMetrics Group, 2009 U.S. Proxy Voting Guidelines Summary, Dec. 24, 2008, <http://www.usfunds.com/media/files/pdfs/compliancepolicies/RMG2009SummaryGuidelinesUnitedStates.pdf>.

²⁴ See Shearman & Sterling LLP, 2009 Director and Executive Compensation Survey, www.shearman.com/corporategovernance.

²⁵ The TARP Regulations require all TARP recipients to hold a say-on-pay vote. In addition, in 2008, 11 of the 100 companies surveyed held say-on-pay votes in 2008, and three additional companies agreed to hold say-on-pay votes in the future. See Shearman & Sterling LLP, 2009 Director and Executive Compensation Survey, www.shearman.com/corporategovernance. See also, The Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009).

TARP is a notable departure from this theme. The TARP regulations (and now the Fed Guidance and the TARP authority conferred upon the Special Master) appear to be based, at least in part, on the notion that certain pay arrangements are inherently objectionable and that shareholder oversight of compensation arrangements is not sufficient. The result is a prescription for pay and benefits at the federal level, at least for TARP recipients and Bank Organizations.

We nevertheless think that it is unlikely that broad restrictions on compensation will extend beyond the financial organizations covered by the TARP Regulations and Fed Guidance. We do expect that there has been enough interest in say-on-pay from institutional shareholders, proxy advisory firms, Congress, Treasury and other regulators that the push for nonbinding shareholder votes on compensation will likely be a continuing trend, if not the subject of Congressional action in the near future. In addition, the SEC and proxy advisory firms will likely demand that companies demonstrate through their annual disclosures that their compensation-setting practices and policies adhere to the emerging “best practice” principles.

What To Expect Going Forward

The context in which the Special Master Rulings and the Fed Guidance arise may be specific to the financial services industry and largely a reaction to the recent financial crisis. Nonetheless, both the Special Master Rulings and the Fed Guidance capture themes that are emerging in the broader compensation landscape. If, as we suspect, the Special Master Rulings and Fed Guidance are indicative of the shape of the future compensation landscape, then we can anticipate that:

- Efforts to place a hard cap on pay will be abandoned in favor of a reallocation among types of compensation.

- Companies will continue to tailor executive pay to keep pace with competitors.
- Performance-based compensation will continue to be an important component of compensation, but will be subject to longer vesting and transferability restrictions and will be based on measurable and objective, long-term performance goals.
- Compensation in the form of stock will continue to be prevalent, but leveraged equity instruments will be disfavored.
- The relationship between pay and risk will be an increasingly important consideration in the compensation setting process and in compensation disclosure. The focus on risk management will likely lead to longer term performance periods, and may well lead to year-over-year netting and reductions in the use of cash and leveraged equity bonus awards.
- There will be continued pressure on directors to justify new or renewed severance arrangements and to reduce or eliminate existing severance and change in control packages.
- There will be continued scrutiny of and skepticism over SERPs, perks, and tax gross-ups.
- Say-on-pay advisory votes will become more prevalent, and investors will continue to seek a seat at the table in compensation decisions.

What, of course, is less easy to predict is whether the realignment of executive pay practices described above will actually make U.S. public companies more competitive or result in a greater convergence of executive and investor interests. That will be measured, if at all, only with the passage of time.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Linda E. Rappaport
New York
+1.212.848.7004
lrappaport@shearman.com

John J. Cannon III
New York
+1.212.848.8159
jcannon@shearman.com

Jeffrey P. Crandall
New York
+1.212.848.7540
jcrandall@shearman.com

Kenneth J. Laverriere
New York
+1.212.848.8172
klaverriere@shearman.com

Doreen E. Lilienfeld
New York
+1.212.848.7171
dllilienfeld@shearman.com

George Spera
New York
+1.212.848.7636
gspera@shearman.com