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Client Publication

Executive Compensation & Employee Benefits | June 22, 2009

Treasury Releases Executive Compensation Regulations for TARP Recipients

The U.S. Department of the Treasury ("Treasury") has released the regulations implementing the executive compensation rules enacted under the American Recovery and Reinvestment Act of 2009 ("ARRA") for entities receiving governmental financial assistance under the Troubled Assets Relief Program ("TARP"). The Interim Final Rule on TARP Standards for Compensation and Corporate Governance, published in the Federal Register on June 15, 2009 (the "Regulations"), supersedes existing regulations under Section 111 of the Emergency Economic Stabilization Act of 2008 ("EESA").[1] The Regulations resolve some of the ambiguities of ARRA, and introduce new issues that TARP entities will need to consider in planning and structuring compensation of both executive and non executive employees.[2]

Identifying Entities and Individuals Subject to the Regulations

Scope of Entities Covered by the Regulations

The Regulations apply to any entity (each a "TARP Recipient") that "has received or holds a commitment to receive" funds through Treasury's purchase of troubled assets under TARP. TARP Recipients also include entities that would be considered part of a TARP Recipient's parent-subsidiary "controlled group" as defined under Section 414(b) or 414(c) of the Internal Revenue Code of 1986, as amended (the "Code"), but applied using a test of only 50 percent common control rather than 80 percent.[3]

[1] For more information on executive compensation requirements under ARRA and EESA, you may refer to the following Shearman & Sterling publications: "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] This publication focuses exclusively on the provisions of the Regulations that apply to TARP Recipients receiving financial assistance under the Capital Purchase Program. Unless expressly stated otherwise, this publication does not discuss the provisions of the Regulations that apply only to TARP Recipients receiving "exceptional assistance."

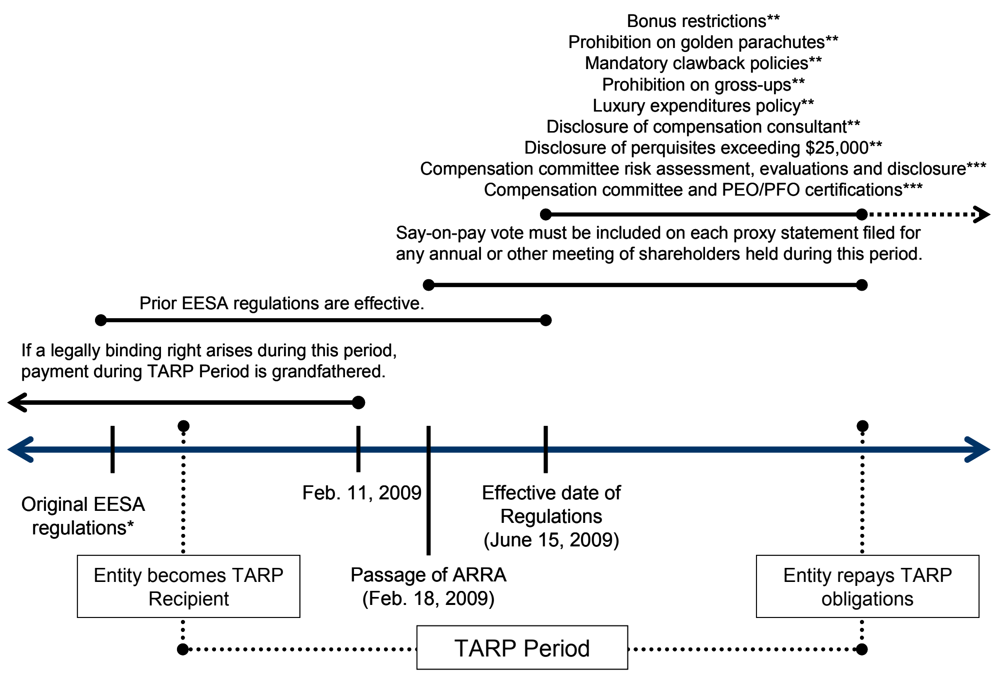
[3] Non-TARP Recipients that are in a brother-sister controlled group with the TARP Recipient are not considered TARP Recipients under the definition.

Most of the provisions of the Regulations are effective during the "TARP Period." The TARP Period begins when the TARP Recipient receives TARP funds or fund commitments and ends when the TARP Recipient no longer has any outstanding obligations to Treasury (other than warrants to purchase common stock held by Treasury). Thus, after a TARP Recipient participating in the Capital Purchase Program repurchases the preferred stock that it issued to the government, it is no longer in the TARP Period even though warrants to purchase common stock may remain outstanding.

The Regulations also state, however, that any specific contractual provisions in individual agreements between TARP Recipients and Treasury remain in effect to the extent they are consistent with ARRA and the Regulations. The executive compensation provisions in the form Securities Purchase Agreement (the "SPA") that was entered into between certain TARP Recipients and Treasury before the enactment of ARRA provide that for the entire period during which Treasury owns any debt or equity securities acquired under the SPA, including any warrants, the TARP Recipient must remain in compliance with Section 111(b) of EESA or any corresponding regulations *as in effect on the closing date of the transactions under the SPA*. Thus, it is possible that a TARP Recipient that has repaid its TARP obligations but has warrants that remain outstanding to Treasury would be required to comply with the prior EESA requirements (to the extent they are deemed to be consistent with the Regulations) after the TARP Period.

The following timeline illustrates the overlapping periods during which the various compensation provisions set forth in EESA, ARRA and the Regulations are effective:

Table 1: Timeline of Effective Dates



*EESA is governed by several Treasury regulations, including Treas. Interim Final Rule, 31 CFR Part 30; Treas. Notice 2008 PSSFI; and Treas. Notice 2008-TARP.

**It should be noted that due to nuances with respect to the trigger date(s) set forth in Table 3 below, the applicability of some of these provisions may extend beyond the TARP Period.

***The certifications and disclosure must be made for any fiscal year during any part of which the TARP Recipient was in the TARP Period.

Additionally, a TARP Recipient may repay all its government obligations, leaving Treasury with only warrants to purchase its common stock and therefore ending the TARP Period. Thereafter, if Treasury exercised those warrants, it may be possible to interpret the Regulations as requiring the TARP Recipient to continue complying with certain provisions of the Regulations until Treasury disposes of the underlying common stock. The extent to which this might allow Treasury to continue exerting authority over TARP Recipients that have repaid their TARP obligations is unclear, but will likely be of interest to the institutions that are currently in the process of repayment.

One unexpected feature of the Regulations is the special rule for business combinations, which may operate to remove certain TARP Recipients acquired by unaffiliated non-TARP Recipients from the reach of the Regulations. In the event of an acquisition "of any form," the purchasing entity and its employees following the transaction—including former employees of the TARP Recipient—will no longer be subject to the Regulations. The Regulations, however, include an anti-abuse clause stating that if the "primary purpose" of the transaction is to "avoid or evade" the requirements, then the purchaser will be treated as a TARP Recipient.

Covered Employees

ARRA's executive compensation provisions generally apply to senior executive officers (the "SEOs") and to a certain number of "most-highly compensated employees," as specified in the relevant provision (in each case, the "Covered Employees") and summarized in Table 2.[4] "Most-highly compensated employee" is defined as an employee of the TARP Recipient, other than the SEOs, who had the highest total annual compensation in the TARP Recipient's last-completed fiscal year. It is important to note that most-highly compensated employees include not only executives, but also non-executive employees without policy-making functions. Total annual compensation is calculated by reference to the amount used to determine "most highly compensated executive officers" pursuant to Instruction 1 to Item 402(a)(3) of Regulation S-K under the Securities Act.[5] Although public TARP Recipients will be familiar with this concept, the total annual compensation analysis will be new for most private TARP Recipients.

The Regulations acknowledge the possibility that the use of total annual compensation to identify each year's most-highly compensated employees might lead to movement of individuals in and out of the Covered Employee designation from year to year. As proposed, the Regulations do not provide specific guidance on this point but request public comment on methods to mitigate the risk that TARP Recipients might intentionally cycle employees through Covered Employee status in order to avoid the restrictions in certain years.

[4] SEO is defined in the same manner as "named executive officer" pursuant to Item 402(a)(3) of Regulation S-K under the Securities Act of 1933, as amended (the "Securities Act").

[5] Item 402(a)(3) determines the most highly-compensated executive officers with reference to the total amount of compensation disclosed in column (j) of the Summary Compensation Table required under Item 402, minus the pension accruals and above market earnings on deferred compensation disclosed in column (h). It should be noted, however, that recent statements by Mary Schapiro, Chairman of the Securities and Exchange Commission ("SEC"), indicate that the SEC may be rethinking the executive compensation disclosure requirements, including rule changes that may affect how Covered Employees are identified.

The following chart summarizes the application of the various provisions of the Regulations to Covered Employees:

Table 2: Covered Employees

Restriction[6]	Covered Employees
Prohibition of bonus, retention awards or incentive compensation Required annual disclosure of any perquisite whose total value for the TARP Recipient's fiscal year exceeds $25,000	Depends on amount of financial assistance: ▪ Less than $25 million: highest-compensated employee. ▪ At least $25 million but less than $250 million: at least the five most highly-compensated employees. ▪ At least $250 million but less than $500 million: SEOs and at least the 10 next most highly-compensated employees. ▪ $500 million or more: SEOs and at least the 20 next most highly-compensated employees. Determination of the threshold amount is made by looking at the TARP Recipient's amount of financial assistance as of the last day of the immediately preceding fiscal year.
Prohibition of golden parachute payments	SEOs and five next most highly-compensated employees.
Mandatory clawback policy Prohibition of gross-ups	SEOs and 20 next most highly-compensated employees.

It appears that new hires will not be Covered Employees during the first fiscal year of their service because Covered Employees are identified based on their previous year's compensation. As such, any signing bonus or other "make-whole" payment paid in the year of hire would be permitted, unless the payment was contingent upon a service requirement that extended beyond the first fiscal year. The portion of any payment that was attributed to service after the first fiscal year would be prohibited. Furthermore, payment (even if fully accrued in the first year) would be prohibited in any later year so long as the individual is a Covered Employee. Make-whole payments are common in the financial services industry and are often used to recruit and retain former employees of competitors who typically forfeit unvested long-term deferred compensation if they terminate employment. Ironically, the Regulations may give TARP Recipients incentive to pay a signing bonus or make-whole payment outright in the first year rather than subjecting the payment to performance or retention provisions, as is currently common practice.

Timing of Compensation and Triggers to Restrictions

Among the issues of immediate concern to TARP Recipients is the timing of the application of the various provisions of the Regulations. The Regulations explicitly provide that the TARP Period extends retroactively. Therefore, TARP Recipients that received assistance from Treasury before June 15, 2009 (the effective date of the Regulations) are deemed to be in the TARP Period, even though the Regulations were not then effective. Entities that repay TARP obligations are generally no longer subject to the compensation restrictions thereafter, but to the extent certain compensation was earned or accrued during the TARP Period, restrictions may continue to apply.

[6] Each of these restrictions is discussed in more detail below.

The dates on which compensation accrues, payments are made, and policies are put in place that can have a significant effect on compensation planning. The following chart illustrates the applicable trigger events for certain provisions under the Regulations.[7]

Table 3: Timing Considerations

Provision	Applicable Trigger Date(s)	Rule	Timing Considerations
Golden Parachute Prohibition	Date of departure; or Effective date of change in control.	Golden parachute payments are prohibited if the date of departure or change in control occurs during the TARP Period on or after June 15, 2009.	<u>Scenario One</u>: If the departure or change in control occurs within the TARP Period, but the payment is made after the TARP Period, the payment is prohibited. <u>Scenario Two</u>: If the departure or change in control occurs prior to the TARP Period, but the payment is due during the TARP Period, the payment is permitted.
Bonus Restrictions	Date of *payment*; or Date of *accrual* (<u>i.e.</u>, service period on which bonus is based). Accrual includes granting of service credit.	Payments subject to restrictions may not be *accrued* or *paid* during the TARP Period. ("*Bonus*" refers to any bonuses, retention awards, and incentive compensation, as defined in Table 4 below, that are not exempted from the restrictions.)	<u>Scenario One</u>: Bonuses are accrued before the TARP Period but payments are scheduled during the TARP Period. Accrual remains, but the payment must be delayed until after the TARP Period.[8] <u>Scenario Two</u>: Bonuses are accrued during the TARP Period (and not paid pursuant to a preexisting employment contract), but payments are scheduled for after the TARP Period. The accrual is prohibited, so the bonus payment is restricted. <u>Scenario Three</u>: Bonuses scheduled to be paid after the TARP Period are partially accrued during the TARP Period and partially accrued after the TARP Period. The payment must be reduced to eliminate the portion of the bonus accrued during the TARP Period, but the payment may be made after the TARP Period.

[7] The definitions and specific rules applicable to these provisions are discussed in more detail below.

[8] Any potential alteration of payment schedules pursuant to the Regulations may raise concerns about violations of Section 409A of the Code. Treasury and the Internal Revenue Service have advised that the delay of the payment of any restricted bonus pursuant to the Regulations will not result in a violation of Section 409A of the Code so long as these payments are made promptly following the first date upon which the payments would be allowed. For more information about Section 409A of the Code, see the following Shearman & Sterling publications: "The New Paradigm for Deferred Compensation: Treasury and IRS Rewrite the Rules of the Road in Sweeping Regulations Interpreting Section 409A," available at www.shearman.com/eceb_101305 and "Treasury and IRS Release Guidance for Non-Qualified Deferred Compensation Plans," available at www.shearman.com/eceb_1204.

Timing Considerations (Cont'd)

Provision	Applicable Trigger Date(s)	Rule	Timing Considerations
Exception for Bonuses Paid Pursuant to Certain Preexisting Employment Contracts	Date on which an employee has a legally binding right to payment of the bonus.	The bonus restrictions do not apply if the employee had a legally binding right to the payment under a contract executed on or before February 11, 2009.	Amounts payable under award agreements and grants under compensation plans—even if they are subject to vesting conditions during the TARP Period—are permitted so long as the awards are payable in accordance with the terms of an enforceable arrangement in effect as of February 11, 2009. If an employee is eligible for a bonus pursuant to a pre-February 11, 2009 employment agreement (or a compensation plan that pre dates the TARP Period), the bonus exception will not apply to any award determination made after February 11, 2009.
Clawbacks	First date upon which a Covered Employee obtains a legally binding right to a bonus payment.	Bonus payments are subject to recovery or clawback by the TARP Recipient if they are based on materially inaccurate financial statements or any other materially inaccurate performance metric, unless the TARP Recipient demonstrates the repayment is unreasonable.	If a TARP Recipient pays a bonus during the TARP Period, but after the TARP Period determines that the bonus was based on materially inaccurate information, then the bonus will remain subject to the clawback provisions.
Prohibition of Tax Gross-Ups	Date upon which a Covered Employee is provided, or is provided a right to, a tax gross-up payment.	TARP Recipients are prohibited from providing tax gross-ups during the TARP Period.	If a TARP Recipient provides a right to a gross-up payment that is payable at a future date, including a date after the TARP Period, the payment remains prohibited.

Rewrite the Rules of the Road in Sweeping Regulations Interpreting Section 409A," available at www.shearman.com/eceb_101305 and "Treasury and IRS Release Guidance for Non-Qualified Deferred Compensation Plans," available at www.shearman.com/eceb_1204.

Key Restrictions on Compensation

Limitations on Bonus Payments

ARRA prohibits any TARP Recipient, during the TARP Period, from paying or accruing any bonus, retention award or incentive compensation to Covered Employees, except in the form of long-term restricted stock that is subject to vesting and transfer restrictions and that does not exceed one-third of the Covered Employee's total annual compensation in the year of grant.

The Regulations clarify the types of payments and accruals that fall under the definitions of bonus, incentive or retention awards. The general forms of compensation that are permitted and prohibited are summarized below:

Table 4: Permitted versus Prohibited Compensation

Permitted Compensation	Prohibited Compensation
▪ Base Pay. Payments made at a regular hourly, daily, weekly, monthly, or similar periodic rate ("Base Pay"). ▪ Qualified Retirement Benefits. Employer contributions to a tax qualified retirement plan. ▪ Welfare Benefits. Benefits under a broad-based benefit plan (either an employee welfare benefit plan or other "usual and customary plans" such as dependent care, tuition reimbursement, group legal services or cafeteria plans, but not deferred compensation or severance plans).[9] ▪ Other Routine Payments. Bona fide overtime pay and routine expense reimbursements. ▪ Grandfathered Payments. Payments made pursuant to a valid employment agreement under which the employee received a legally binding right to the payment on or before February 11, 2009.[10] ▪ Commissions. Commission compensation generally based on sales made or services provided to unrelated parties in the ordinary course of business, or based on management of unrelated clients' money. ▪ Long-Term Awards. Restricted shares or restricted stock units that do not exceed one-third of the employee's total annual compensation (as defined below) and comply with the forfeiture and transfer restrictions of the Regulations.	▪ Bonus. Any payment that is not Base Pay (other than grandfathered payments or long-term awards). ▪ Retention Award. Any compensation other than Base Pay (other than grandfathered payments or long-term awards) that is (i) contingent on the completion of a future service period or a specific project and (ii) is not based on the TARP Recipient's or the employee's performance (other than forfeiture of the payment due to termination from employment for cause). ▪ Incentive Compensation. Any compensation intended to serve as incentive for performance to occur over a specified period, whether measured based upon financial performance of the TARP Recipient, the TARP Recipient's stock price, or any other performance measure, and any stock, stock option, or other equity compensation that is not considered Base Pay (other than grandfathered payments or long-term awards).

Alternatives for performance-based compensation

Although the Regulations are restrictive, they appear to allow TARP Recipients to structure compensation arrangements to introduce some component of variability tied to individual or firm performance. First, TARP Recipients may pay base salary in the form of equity with the potential for appreciation or depreciation based on the performance of the TARP Recipient or a subdivision of the TARP Recipient, as described in more detail below. Second, TARP Recipients can use the limited long-term restricted stock exception to pay awards of restricted stock or restricted stock units, which may be structured to include individual or firm-based performance criteria in addition to the required service-based forfeiture and TARP repayment-based transfer restrictions. Third, some forms of performance-based compensation should fall within the limited exception for "commission compensation."

9 Employee welfare benefit plan is defined by reference to Section 3(1) of ERISA.

10 The grandfathering provisions are discussed in Table 3 above.

- ***Payments within the Scope of Base Pay***. There is no restriction on the amount of Base Pay that a Covered Employee can receive.[11] While the Regulations specifically provide that bonuses cannot be masked as salaries, there may be ways to apply some risk and opportunity to Base Pay. First, Base Pay may be paid or accrued not only in cash, but also in property or in stock units meeting certain requirements under the Regulations.[12] This means that a portion of Base Pay could potentially be paid out in periodic grants of stock, or grants of stock units or similar awards. In order to pay any portion of a Covered Employee's Base Pay in the form of stock (or other property) or stock units, the following conditions must apply:

  - The stock or stock unit cannot be subject to a substantial risk of forfeiture;[13]
  - The grant cannot be contingent on the provision of future services;
  - The number of shares of stock or stock units granted must be based on a specific dollar amount on the date of grant; and
  - The stock or stock units must be accrued at the same time as the Base Salary would otherwise accrue if it were paid in cash.

  Moreover, the Base Pay may consist of a stock unit based either on (i) the TARP Recipient's stock, or (ii) the actual or notional common stock of an entity, division or other unit of the TARP Recipient. As long as the conditions are met, a TARP Recipient could grant Covered Employees stock units whose value is tied to the value of a specific division of the TARP Recipient. While the TARP Recipient could not subject these amounts to a vesting or service requirement, any property or units granted as Base Pay may be subjected to transfer restrictions.

- ***Long-Term Restricted Stock***. TARP Recipients can grant long-term restricted stock or restricted stock units that meet the following criteria:

  - The restricted stock or stock unit must be based on the common stock of the TARP Recipient (or a specified division or other unit of the TARP Recipient). Similar to the Base Pay allowance for the granting of property, this requirement may allow TARP Recipients to tailor the potential value of awards to the contributions of individual employees by allowing the use of actual or notional equity of subdivisions of the TARP Recipient.
  - The restricted stock or stock unit must be forfeited if the Covered Employee terminates employment within two years of the grant date for any reason other than death, disability or a change in control. Accelerated vesting upon termination of employment without cause or resignation for good reason is not allowed.

[11] There was some speculation about whether Treasury would impose an overall limit on compensation amounts after it issued its February 4, 2009 guidance stating that entities that received "exceptional assistance" would be subject to an overall compensation limit of $500,000 per year for each Covered Employee. The Regulations adopted a variation of this concept in the safe harbor rule for entities receiving exceptional assistance whereby any Covered Employee's compensation that is less than $500,000 will automatically be deemed compliant.

[12] While the Regulations do not explicitly define "property," Treas. Reg. § 1.83-3(e) provides some guidance. It defines property to include any real or personal property other than money or an unfunded and unsecured promise to pay money or property in the future. Although an option to purchase common stock may be viewed as property under this definition if it has a readily ascertainable fair market value, Section 83 provides special rules applicable to the tax treatment of typical nonstatutory stock options. However, it is unclear whether nonstatutory stock options would be considered property under the Regulations.

[13] "Substantial risk of forfeiture" for this purpose is defined in the same manner as in Section 83 of the Code. *See* Treas. Reg. § 1.83-3(c). The use of the broader Section 83 definition of substantial risk of forfeiture instead of the narrower definition used in Section 409A of the Code limits some of the flexibility of applying this condition to Base Pay paid in property.

- Up to 25 percent of the restricted stock or stock unit may become transferable (or payable) for each 25 percent of the TARP obligations that are repaid.[14]
- The value of the restricted stock or stock unit grant may not exceed one-third of the Covered Employee's total annual compensation in the year of grant (including the restricted stock or stock unit grant).
  - Total annual compensation is generally calculated in the same manner as for purposes of identifying the Covered Employees (as described in footnote 5). However, the value of restricted stock or stock units is calculated as of the date of grant without regard to vesting requirements, even for multi-year grants, and without regard for accounting expense or future appreciation of the value of the stock (e.g., $500,000 in restricted stock units that vest in five equal installments over five years would be counted as $500,000 in the year of grant, not $100,000 per year).

- ***Payments that Qualify as Commissions***. TARP Recipients can also determine whether any components of a Covered Employee's compensation qualify as "commission compensation." In general, commission compensation must be paid consistently with a program established prior to February 17, 2009, must be calculated based on sale price or volume of sales to third-party customers and must be contingent on receipt of payment or the closing of the sales. The commission compensation rules also exempt as commissions certain compensation based on asset-based fees related to third-party open-ended asset management services. However, compensation in the form of fees related to proprietary trading or for management of closed-end funds is prohibited.

  Compensation based on a specified transaction—such as an initial public offering or a sale or acquisition—also does not qualify as commission compensation. The Regulations state that even if services rendered in connection with corporate transactions (e.g., managing initial public offerings) is in the TARP Recipient's ordinary course of business and is a substantial part of the Covered Employee's job, commissions based upon these transactions do not qualify as commissions.

The Regulations seem to prohibit a bonus based on the repayment of all TARP obligations, unless the bonus complied with the long-term restricted stock requirements.

Prohibition on Golden Parachute Payments

The Regulations prohibit golden parachute payments, which include all payments made to a Covered Employee upon (i) his departure for any reason other than death or disability, or (ii) the effective date of a change in control of the TARP Recipient, other than the payments set forth in the following chart:

[14] Because the long-term restricted stock (or stock unit) must be subject to forfeiture for at least two years, it appears that even if the TARP obligations are repaid within two years of the grant date, the award must remain subject to the transferability restrictions until the second anniversary of the grant date.

Table 5: Permitted Severance Payments

Form of Payment	Eligibility Criteria
Payments for Services Performed and Benefits Accrued	▪ Payment would be made regardless of (i) the facts of or circumstances surrounding the Covered Employee's departure (with a limited exception for forfeiture of a payment upon for-cause termination) or (ii) the occurrence of the change in control event.[15] ▪ Timing of payment cannot be accelerated upon departure or change in control. ▪ Payments under deferred compensation plans are not considered payments for services performed and benefits accrued.
Payments Made Pursuant to a Deferred Compensation Program or Benefit Plan	Payment meets all of the following conditions: ▪ Payments are made pursuant to the terms of a plan that was in effect for at least one year prior to the Covered Employee's departure; ▪ Payments are fully vested as of the departure date or change in control event; ▪ Benefits under the plan accrued only for current or prior service; ▪ Payments are not based on a discretionary acceleration of vesting or accrual of benefits; and ▪ TARP Recipient has (i) recognized expense and accrued a liability in prior years for the payments or (ii) set aside assets for the payments with a trust.[16]
Retirement Payments	Retirement plan is qualified or is intended to be qualified under Section 401 of the Code or under the laws of any applicable foreign jurisdiction.
Other Payments on Termination of Employment	Payments made upon termination of employment due to death or disability.
Payments Required to be Made Under State or Foreign Law	Severance payments required under a state statute or foreign law that is applicable to all employers in the jurisdiction.

Notably, any golden parachute payment is deemed to have been made on the date of the Covered Employee's departure or the date of the change in control event, regardless of the actual payment date. In other words, if a Covered Employee terminated from employment during the TARP Period and was entitled to a severance payment payable over multiple years, and the day after the Covered Employee's departure, the TARP Recipient repaid all financial obligations and was no longer in the TARP Period, the severance payment would still be prohibited.

[15] For example, if a Covered Employee has accrued a multi-year equity award with a five-year vesting schedule, and under the terms of the award, he forfeits the award if he resigns without good reason, the award would be prohibited as a golden parachute payment. Alternatively, if he is entitled only to the portion of the award that has vested as of his resignation, it is permitted.

[16] Supplemental retirement plans would have to meet all of the criteria of the deferred compensation plan exception in order for a Covered Employee who departs during the TARP Period to receive benefits accrued under the plan.

Mandatory Clawback Policies

The Regulations require that during the TARP Period, any bonus payments made by a TARP Recipient to a Covered Employee must be subject to a clawback provision. The provision must allow for the clawback or recovery of the bonus payment if it was based on "materially inaccurate financial statements or any other materially inaccurate performance metric criteria."

Table 6: Clawback Determinations

How can a financial statement or performance criteria be materially inaccurate?	
Step 1	Has a Covered Employee *knowingly* (i) engaged in providing inaccurate information relating to the financial statements or performance metric criteria or (ii) failed to timely correct information relating to the financial statements or performance metric criteria? ▪ If YES → the financial statement or performance criteria is deemed materially inaccurate for that Covered Employee. ▪ If NO → proceed to Step 2.
Step 2	Is the actual performance materially different from the performance required under the performance criteria? – or – Is the accurate application of the actual performance to the performance criteria materially different from the inaccurate application of the actual performance to the performance criteria? ▪ If YES → the financial statement or performance criteria is deemed materially inaccurate for all affected Covered Employees. ▪ If NO → the financial statement or performance criteria is not deemed materially inaccurate.

The clawback requirement applies (during and after the TARP Period) for any bonus payment to which a Covered Employee obtains a legally binding right during the TARP Period. For this purpose, bonus payments include all bonuses and incentive compensation, as defined above, as well as payments that were grandfathered due to a pre-February 11, 2009 agreement. Accordingly, the clawback does not apply to compensation structured as Base Pay or commission, and, as a practical matter, the only compensation potentially subject to the clawback (for employees subject to the bonus restrictions) would be long-term restricted stock and grandfathered awards.

The Regulations provide that the TARP Recipient must exercise its clawback rights, unless it can demonstrate that it would be unreasonable to do so, for instance, if the recovery amount would be less than the cost of enforcing the clawback.

Prohibition on Tax Gross-Ups

The Regulations prohibit TARP recipients from providing tax gross-ups to Covered Employees during the TARP Period, other than certain tax equalization amounts for expatriates. The SEC rules currently require public companies to disclose gross-up arrangements in their annual proxy filings. Shareholder activists have generally disapproved of gross-up payments. This prohibition includes providing a right to a payment of a gross-up at a future date.

Expanded Regulation of Compensation-Setting Procedures and Disclosures

The Regulations set forth a number of new requirements for the planning, structuring and disclosure of compensation. Generally, the Regulations expand the role of a TARP Recipient's board of directors, set forth numerous new disclosure requirements, and require new certifications both by the compensation committee and the company's principal executive officers. The following chart summarizes the major compliance items for TARP Recipients.

Table 7: Deadlines for New Procedures and Disclosures

By the later of 90 days after (i) the closing date of the agreement between the TARP Recipient and Treasury or (ii) June 15, 2009	
TARP Recipient must establish a wholly-independent compensation committee.[17] The board of directors must adopt an excessive or luxury expenditures policy, provide the policy to Treasury and the TARP Recipient's primary regulator, and post the text of this policy on the company's website.	
Every 6 months	
The compensation committee must discuss, evaluate and review the following with the TARP Recipient's senior risk officers: ▪ All SEO compensation plans to ensure they do not encourage unnecessary and excessive risk taking. ▪ All employee compensation plans in light of the risks posed to the TARP Recipient and how to limit such risks. The compensation committee must discuss, evaluate and review all employee compensation plans to ensure these plans do not encourage the manipulation of reported earnings.	
Every fiscal year, during any portion of which is a TARP Period	
In the Compensation Committee Report in the annual proxy statement (for private TARP Recipients, within 120 days following the completion of each fiscal year).[18]	Compensation committee must provide a narrative disclosure describing its review of compensation plans. Compensation committee must certify that it has conducted the required risk assessment, evaluation, and amendment of compensation plans.
Within 90 days following the completion of a fiscal year.	The principal executive officer ("PEO") and principal financial officer ("PFO") must certify compliance with each requirement of the Regulations and provide a list of SEOs and most-highly compensated employees.
Within 120 days following the completion of a fiscal year.	Each TARP Recipient must provide to Treasury and the TARP Recipient's primary regulator a narrative disclosure of perquisites in excess of $25,000 to each of the SEOs and most highly-compensated employees. Compensation committee must provide to Treasury and the TARP Recipient's primary regulator a narrative disclosure of compensation consultant.

Expanded Duties of the Board of Directors

Traditional principles of corporate governance are derived from state law, which has historically protected a board of directors' compensation decisions in the same manner as other operational and strategic business decisions under the business judgment rule. Boards of directors have the right to, and in most cases do, delegate to management the day-to-day decision-making authority for operating the company, including determining non-executive compensation. The board and management are free to use any processes they deem appropriate to evaluate, review, and structure compensation so long as they fulfill their state common law duties of care and loyalty. The Regulations not only expand the duties of the board to

[17] The independence of the directors serving on the compensation committee is determined pursuant to Item 407(a) of Regulation S-K under the Securities Act.

[18] The Regulations require the inclusion of the narrative disclosure and the certification "in the Compensation Committee Report pursuant to Item 407(e) of Regulation S-K," which could be more than once in the same year. The narrative disclosure and certification must also be provided to Treasury and, in the case of a private TARP Recipient, to the TARP Recipient's primary regulator.

review non-executive employee compensation, they also mandate specific processes and standards that the board must follow or adhere to in its evaluations.

Compensation Committee Review

All TARP Recipients are required to establish and maintain independent compensation committees, which must adhere to the following requirements:

Table 8: Compensation Committee Requirements

Risk Assessment	The compensation committee must, at least every six months, ***discuss, evaluate and review*** with the TARP Recipient's senior risk officers any risks that threaten the value of the TARP Recipient. Risks include encouraging employee behavior focused on short-term results and not long-term value creation.
Evaluation of Plans	The compensation committee must, at least every six months, ***discuss, evaluate and review*** with the TARP Recipient's senior risk officers all ***SEO compensation plans*** to ensure they do not encourage the SEOs to take unnecessary and excessive risks. The compensation committee must, at least every six months, ***discuss, evaluate and review*** with the senior risk officers all ***employee compensation plans*** in light of the risks posed to the TARP Recipient by such plans and how to limit such risks. The compensation committee must, at least every six months, ***discuss, evaluate and review*** all ***employee compensation plans*** to ensure these plans do not encourage the manipulation of earnings of the TARP Recipient. These evaluations must be made every six months.
Amend Plans to Comply with New Standards	The compensation committee must ***limit*** the features of all SEO compensation plans and employee compensation plans that could encourage SEOs to take unnecessary or excessive risks or could otherwise expose the TARP Recipient to unnecessary risks. The compensation committee must ***eliminate*** the features of employee compensation plans to ensure these plans do not encourage the manipulation of reported earnings.
Certification	The compensation committee must certify that it has conducted the required risk assessment, evaluation, and amendment of compensation plans. The Regulations provide a model certification.*
Disclosure	At least once per fiscal year, the compensation committee must provide a narrative description, in which it must: Identify each SEO compensation plan and explain how each plan does not encourage the SEOs to take unnecessary and excessive risks that threaten the value of the TARP Recipient. Identify each employee compensation plan and explain how any unnecessary risks posed by the plan have been limited and how the plan does not encourage the manipulation of reported earnings to enhance the compensation of any employee.*
*For TARP Recipients with securities registered with the SEC, the compensation committee must provide the certifications and disclosures in the Compensation Committee Report required pursuant to Item 407(e) of Regulation S-K under and to Treasury. A TARP Recipient that is a smaller reporting company must provide the certifications to its primary regulator and to Treasury within 120 days of completion of a fiscal year.	

The expansion of the duties of the compensation committee will require a significant new undertaking by the committee. A large organization could have many different employee compensation plans. Requiring a small group of board members, all of whom are required to be independent (and thus likely do not have first-hand knowledge of the lower level operations of the company) to review every employee compensation plan is a demanding requirement. Imposing these obligations on independent directors every six months will likely make it more difficult for TARP Recipients to find individuals willing to serve on their compensation committees.

Luxury Expenditures Policy

The Regulations require the board of directors of each TARP Recipient to adopt a luxury expenditures policy. Excessive or luxury expenditures are defined in the Regulations as excessive expenditures on any of the following: (i) entertainment or events, (ii) office and facility renovations, (iii) aviation or other transportation services, and (iv) other similar items, activities or events for which the TARP Recipient may reasonably anticipate incurring expenses, or reimbursing an employee for incurring expenses.

The policy must include the following:

- Written standards for each category of expense;
- A description of which expenses are prohibited and which require prior approval, which description may include an overall threshold limit or a per-employee limit;
- A provision for reasonable approval procedures;
- A requirement that the principal executive officers certify that approval was obtained for each expenditure for which approval was required; and
- A requirement for the internal reporting of violations.

These categories of expenditures go beyond the perquisites that are required to be disclosed with respect to SEOs under the SEC disclosure rules by including expenditures available to rank and file employees or related to general business operations. There is an exception for reasonable expenditures for staff development, performance incentives and other expenditures in the ordinary course of business; nonetheless, a broad reading of the Regulations could require approval for things such as sending personnel on business trips or holding company holiday parties. These activities may be reasonably viewed by middle managers as training opportunities or morale-boosters.

Additional Disclosures

The Regulations introduce two new disclosure requirements that were not required under ARRA.

- ***Compensation Consultant Disclosure***. A TARP Recipient must describe in narrative form whether the TARP Recipient or its board of directors or compensation committee has engaged a compensation consultant. The disclosure must specify all types of services, including non-compensatory services, provided by the compensation consultant during the past three years. In particular, the disclosure must include any "benchmarking" data or comparisons used to identify certain percentile levels of compensation. The disclosure must be made to Treasury and to the TARP Recipient's primary regulator within 120 days of the completion of a fiscal year, any part of which is in the TARP Period. The Regulations' inclusion of this provision may be a harbinger of future disclosure requirements for all public companies.
- ***Perquisite Disclosure***. TARP Recipients must annually disclose any perquisite whose total value for the fiscal year exceeds $25,000 that is provided to any Covered Employee. The Regulations generally define perquisite in the same way as under the proxy disclosure rules. This disclosure must include a narrative description of the amount, nature, and recipient of the perquisites, as well as a justification for offering the perquisite and the amount of the perquisite, and it must be provided to Treasury and to the TARP Recipient's primary regulator within 120 days of the completion

of a fiscal year any part of which is a TARP Period.[19] While current SEC disclosure rules require disclosure of perquisites paid to an SEO in the Summary Compensation Table, the narrative justification is a new concept. This will require TARP Recipients to maintain detailed records of expenditures and the contexts under which they arose.

New Certification Requirements

The Regulations expand the certification requirements for TARP Recipients, requiring new certifications to be made by both the PEO and PFO, and by the compensation committee. Notably, while the previous EESA regulations required some certifications by the PEO and PFO, the Regulations require that the certifications enumerate each requirement under the Regulations and include a statement that each requirement has been complied with. In addition, the PEO/PFO certification must include a list identifying all Covered Employees, naming non-SEO Covered Employees ranked in order of the amount of their annual compensation for that fiscal year (but without disclosing the amount of compensation). Finally, the TARP Recipient is required to preserve all documentation related to the certifications for a period of at least six years and to furnish the documentation upon request by Treasury. The compensation committee certifications are discussed above. The Regulations include model certification statements.

The PEO and PFO certifications are to be filed as exhibits to the TARP Recipient's Form 10-K disclosures and the compensation committee certifications are to be filed with the Compensation Committee Report in the TARP Recipient's annual proxy statement. To the extent that a TARP Recipient is not a public company, the certifications are required to be filed with both the entity's primary regulator and Treasury. The Regulations make the point that certifications furnished to Treasury are within the scope of 18 USC § 1001, which imposes criminal sanctions on persons making certain fraudulent statements to a federal official. With respect to public TARP Recipients, there is also a possibility that the certifications may impose securities law liability since they are filed with the SEC.

Special Master

The Regulations create the Office of the Special Master for TARP Executive Compensation (the "Special Master"). The Special Master is appointed by the Secretary of the Treasury and can be removed at any time without cause or notice. The Special Master's duties and powers mostly pertain to TARP Recipients receiving "exceptional assistance," which duties include, among others, (i) approving compensation for all executive officers and the 100 other most highly-compensated employees, and (ii) disapproving compensation it deems inappropriate, unsound or excessive.[20] The Regulations give the Special Master a remarkable level of discretion in making these determinations. While a TARP Recipient may request that the Special Master reconsider its determination, the Regulations do not provide for any other appeal process.

TARP Recipients who do not receive exceptional assistance may request a nonbinding advisory opinion of the Special Master regarding whether the TARP Recipient's compensation is inconsistent with Section 111 of EESA or otherwise contrary to the public interest. In making this determination, the Special Master is to consider the following six factors: (i) risk, (ii) maximization of taxpayer return, (iii) appropriate allocation among types of compensation, (iv) the use of performance-based compensation, (v) comparable payments and structures among peer companies, and (vi) employee

[19] It should be noted that even if the TARP Period ends early in the TARP Recipient's fiscal year, the compensation consultant and perquisite disclosures must be made after the completion of the fiscal year.

[20] Entities receiving exceptional assistance are entities that received assistance under the Programs for Systematically Significant Failing Institutions, the Targeted Investment Program, the Automotive Industry Financing Program and any other new program designated by Treasury as providing exceptional assistance.

contributions to overall TARP Recipient value. Because the Special Master's advisory opinions are published, the result will essentially be the development of a body of law interpreting the Regulations, and commenting in a broader sense on the appropriateness of compensation structures.

Conclusion

The passage of ARRA caused a great deal of unease among TARP Recipients due to the ambiguity of the language and the seeming vast amount of authority that was granted to Treasury to interpret the provisions. In many ways, the Regulations provide much of the clarity sought by TARP Recipients. At the same time, ARRA and the Regulations represent one of the most extensive regulatory regimes ever imposed on compensation. Whether the concepts will fuel similar movements in non-TARP companies is yet to be seen. Recently, Treasury, the SEC and Congress have all expressed interest in broader compensation reforms. Regardless, it is important that all companies observe the implementation of the Regulations' provisions since they seem to hint at a broader shift in perceived best practices in compensation planning and structure.

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