

The new executive compensation restrictions

The American Recovery and Reinvestment Act of 2009, commonly known as the “Stimulus Package,” was signed into law on February 17th. The final six pages of the 407-page document contain a new set of executive compensation restrictions designed to ensure that Troubled Asset Relief Program (TARP) funds are directed toward the public interest.

Details of the new restrictions

Certain top executives at institutions receiving TARP funds will be subject to strict bonus restrictions. The bonus provisions will be applicable to the highest-paid employees and the Senior Executive Officers (Proxy Listed Officers) based on the following schedule:

Funds received under TARP	Employees affected
<\$25 MM	1 most highly paid
<\$25–\$249.99 MM	5 most highly paid*
\$250–\$499.99 MM	15 most highly paid*
\$500 MM+	25 most highly paid*

For these executives, the only incentive compensation permitted will be long-term restricted stock which:

- (1) Does not *fully* vest while the company has an “obligation arising from financial assistance” under TARP
- (2) Is capped at one third of the employee’s total annual compensation
- (3) Is subject to other terms that the Secretary of the Treasury deems to be in the public interest

An exception to these restrictions is provided for incentive payments owed under employment agreements dated prior to February 11th, 2009.

In addition, the following provisions apply to all institutions that received funds under TARP:

- The Treasury Secretary will review all compensation paid for 2008 to the CEOs and 20 next most highly-paid executives at each institution and will seek reimbursement for any of those payments which are ruled to be “inconsistent with the purposes of...TARP” or “otherwise contrary to the public interest”
- Mandatory “Clawback” provisions that provide for the recovery of any incentive compensation paid to the CEOs and next 20 most highly-compensated executives that was based on criteria later found to be “materially inaccurate”
- A prohibition on “Golden Parachute” payments for CEOs and 5 next most highly-compensated executives
- Company policy relating to approval of luxury expenditures will be required
- An annual, non-binding, shareholder “Say-on-Pay” vote
- A prohibition on CEO compensation that includes incentives to take “unnecessary and excessive risks”

* *“Or such higher number as the Secretary may determine is in the public interest with respect to any TARP recipient”*

The new executive compensation restrictions are focused on ensuring that Troubled Asset Relief Program (TARP) funds are directed only toward the public interest by strengthening our economy and not toward private gain. The new rules present restrictions that affect an increasing number of employees based on the level of government assistance. All companies that have an ‘obligation arising from financial assistance’ received under TARP will be subject to the provisions detailed in the box to the left.

Questions have immediately arisen as to how a key component of the new restrictions will be implemented.

Who is “Most Highly-Paid”?

The rules do not detail how to determine who the most highly-paid executives are for the purposes of restricting compensation.

- If “most highly-paid” is based on realized compensation (e.g., a W-2 concept) for the prior year, the list will likely change every year as employees exercise stock options, earn bonuses, and receive deferred compensation payouts
- If, on the other hand, most highly-paid is based on the same method used in the summary compensation table of the proxy, equity award expense under FAS123 R could have a significant impact on this determination
- A third potential method would be to use “target” or expected pay rates at the beginning of the year

Treasury is expected to issue clarifying guidelines in the coming weeks. Until then, companies need to be prepared to reset pay levels and the pay structure for those executives impacted by the new rules.

For example, a banking executive subject to the new restrictions could receive a base salary of \$1 million and a restricted stock award valued at \$500 thousand for an annual compensation package of \$1.5 million. While increasing fixed pay may prevent unnecessary risk taking, it moves away from a pay-for-performance model, which is a shared objective of Congress and company shareholders. Companies will have to consider how to best address this limitation in terms of remaining market competitive and retaining a pay for performance philosophy.

Reassessing incentive plans

The new legislation specifically prohibits any “compensation plan that would encourage manipulation of the reported earnings of such TARP recipient to enhance the compensation of any of its employees.” To comply with this part of the law, companies will need to carefully examine the performance metrics used in their incentive compensation plans, and may be reluctant to utilize measures based on or closely tied to reported earnings.

As a majority of performance metrics employed in incentive plans have some relation to earnings, companies should probably delay finalizing the performance metrics used for incentive plans in 2009 until Treasury provides further guidance on this prohibition.

Potential talent implications

The significantly expanded scope of the new executive compensation rules, and the considerable flexibility afforded to the Treasury Secretary in applying the restrictions to accommodate “the public interest,” may present recruitment and retention challenges for TARP recipients.

Proponents of the proposed compensation limits argue that fears of a “human capital flight” from the most beleaguered institutions are overstated, and high performers will be reluctant to seek other employment opportunities. Some proponents also suggest top executives should be willing to work for a reduced level of pay during this “work-out” period, as they will likely be rewarded once the financial institution is restored to complete financial health.

Opponents of the restrictions suggest restrictions may cause some employees to seek employment in smaller unregulated firms or foreign entities that have escaped the worst of the ongoing turmoil. Companies will want to evaluate their talent management and retention strategies in light of these compensation limits.

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Corporate governance: Say-on-Pay

Accompanying the executive compensation restrictions for companies receiving TARP assistance are new rules on corporate governance. With these guidelines, the government aims to set a new standard in accountability for corporations receiving public funds. All TARP-recipients are required to submit to an annual, non-binding, “Say-on-Pay” shareholder vote on the appropriateness of the compensation packages for the Senior Executive Officers.

An initial reading of the requirement to submit a Say-on-Pay vote to shareholders appeared to apply to the 2010 proxy season as Congress gave the SEC one year from the date of enactment to issue regulations on this non-binding shareholder vote.

However, a letter requesting clarification on timing that was submitted to the SEC by the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs on February 20th, expressed the opinion that the Say-on-Pay vote was required for any company filing a proxy statement after February 17th, 2009 – with companies that had filed a preliminary proxy statement as of February 17th exempted. The SEC issued guidance on February 26th, 2009 confirming a Say-on-Pay vote is required this year.

The statute requires a “separate shareholder vote to approve the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the Commission (which disclosure shall include the Compensation Discussion & Analysis, the compensation tables, and any related materials.)”

It is important to note that while Boards are under no obligation to amend the executive pay packages in the event of a large or majority-negative shareholder vote, they could find themselves under pressure to do so. This requirement will require extensive shareholder communication to ensure that all participants in the Say-on-Pay process understand it.

The future

Rules clarifying the implementation of the new restrictions are due to be issued in the coming weeks. The Administration has expressed its concerns over the modified executive compensation restrictions included in the American Recovery and Reinvestment Act, and has suggested that it may work to revise some of the provisions even now that they have become law. As a result, we expect more details regarding the application of the rules to be forthcoming.

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