

# Financial Institutions

## E-ALERT

October 21, 2008

### Executive Compensation Rules for Financial Institutions Participating in the Capital Purchase Program

The Department of Treasury has issued interim final rules providing guidance on the executive compensation standards applicable to financial institutions participating in the Capital Purchase Program ("CPP") established under the Emergency Economic Stabilization Act of 2008 ("EESA"). The rules provide detail and specificity to the standards set forth in Section 111(b) of EESA for institutions in which the Treasury holds a meaningful equity or debt position. Although the rules went into immediate effect, the Treasury is accepting comments until November 19 and will consider the comments in its final rule.

An institution (a "Participating Institution") becomes subject to the new rules immediately upon the Treasury's purchase of securities under the CPP and remains subject to them for the duration of the Treasury's investment. The rules apply to both public and private companies. In the event that a Participating Institution is acquired by an unrelated entity that is not a Participating Institution (or otherwise subject to the executive compensation rules under EESA), the acquirer and its officers will not become subject to the rules solely as a result of the acquisition, and the target and its officers will be subject to the rules until after the first anniversary following the acquisition.

Financial institutions electing to participate in the CPP should review these new rules to assess the implications for their executive compensation and governance policies and procedures. These rules are significant in that they go beyond the existing regime of disclosure-based Federal regulation of executive compensation and governance matters, and represent the first meaningful Federal foray into substantive regulation of these practices. For those participating in the CPP, important practical consequences are discussed briefly below.

1. *Review of Incentive Arrangements by Compensation Committee and Senior Risk Officers.* EESA requires that a Participating Institution impose limits on the incentive compensation of its "senior executive officers" so that they do not have incentives to take unnecessary and excessive risks that threaten the value of the Participating Institution. In general, the "senior executive officers" (the "SEOs") are the five most highly compensated officers of the Participating Institution whose compensation is required to be disclosed in the Participating Institution's proxy statement (or their counterparts in the case of a private company). Participating Institutions will need to identify the SEOs that will be subject to the executive compensation requirements of EESA.

The new rules offer a self-policing mechanism to ensure compliance with this standard. Within 90 days after the Treasury's first purchase under the CPP, the Participating Institution's compensation committee must review the incentive compensation arrangements applicable to the SEOs with the Participating Institution's senior risk officers to ensure that such arrangements do not encourage SEOs to take unnecessary and excessive risks. As part of this process, the compensation committee and senior risk officers should discuss the risks faced by the Participating Institution that could threaten its

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value, and identify those features of its incentive compensation arrangements that could lead CEOs to take such risks. Similar meetings must occur on an annual basis. Further, the compensation committee must certify each year that it has completed a review of CEO incentive compensation and state that it has made reasonable efforts to ensure that such compensation arrangements do not encourage CEOs to take unnecessary and excessive risks that threaten the value of the Participating Institution. This certification must appear in the Compensation Discussion and Analysis of the Participating Institution's proxy statement (or, in the case of private companies, be filed with its primary regulator). While such reviews may be part of existing governance procedures at some companies, financial institutions that participate in the CPP should ensure that these reviews occur in a timely manner and that appropriate documentation of such reviews is made a part of the governance records.

2. *Review and Amend Clawback Policies.* EESA requires that CEO bonus and incentive compensation paid during the period of the Treasury's investment be subject to recovery or "clawback" by the Participating Institution if the payments were based on materially inaccurate financial statements or other materially inaccurate performance metric criteria. The new rules offer guidance on how to structure a clawback policy to meet this requirement. Although similar to the existing clawback provisions in Section 304 of the Sarbanes-Oxley Act of 2002, the new rules are broader than Section 304 in that: (i) the EESA clawback requirements apply to not only the principal executive officer and the principal financial officer, but also the three other most highly compensated executive officers, and apply to private companies as well as public companies, and (ii) the EESA clawback provision is not exclusively triggered by an accounting restatement, does not limit the recovery period, and covers not only material inaccuracies relating to financial reporting but also material inaccuracies relating to other performance metrics used to award bonuses and incentive compensation. While many companies have clawback policies, in some cases these have been crafted so as to reach no further than the requirements of Section 304 of Sarbanes-Oxley. Accordingly, Participating Institutions should review existing clawback policies and, if necessary, adopt or expand them to comply with the new rules.

3. *Review and Amend Golden Parachute Arrangements.* EESA prohibits a Participating Institution from making any golden parachute payment to an CEO during the period of the Treasury's investment. The new rules provide detailed guidance on what constitutes a "golden parachute payment" for participants in the CPP. In general, the rules prohibit any "parachute payment" (as described below) to an CEO that is made in connection with an involuntary termination of employment or a severance from employment in connection with any bankruptcy filing, insolvency or receivership of the Participating Institution. "Parachute payment" has the same meaning as it does under Section 280G of the Internal Revenue Code, namely any payment that equals or exceeds three times the CEO's base amount, which in general is the CEO's average annual base salary and bonus for the last five full years. Participating Institutions should review their employment and severance arrangements with CEOs and, if necessary, amend them to comply with the new rules. (For institutions that fall within the category of "significantly failing financial institutions" that participate in the Treasury's program for these firms, it is important to note that all severance payments to CEOs, no matter the amount, are prohibited.)

4. *Review Tax Consequences of Compensation Arrangements.* As with institutions participating in the Treasury's auction program, Participating Institutions are subject to the new Section 162(m)(5) deduction limitations that have been reduced from \$1 million to \$500,000 and that require companies in calculating such threshold amount to include performance-based compensation (including stock option gains) and deferred compensation for services performed during the applicable year. Participating Institutions should review the tax consequences flowing from these changes as well as the design of their performance-based compensation arrangements in view of the inclusion of these

amounts in the total compensation and the Section 162(m) disclosure in their annual proxy statements.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our employee benefits and corporate and securities practice groups:

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