Treasury Issues TARP Executive Compensation Regulations

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The U.S. Treasury Department has issued its long-awaited rules implementing the executive compensation and governance requirements of Section 111 of the Emergency Economic Stabilization Act of 2008 ("EESA"), as amended by the American Recovery and Reinvestment Act of 2009 ("ARRA").[1] On June 10, 2009, Treasury released an interim final rule ("IFR") covering firms that receive financial assistance under the Troubled Asset Relief Program ("TARP").[2] The IFR will be effective immediately upon publication in the Federal Register, which is scheduled for June 15, 2009 ("Effective Date"). However, public comment is invited on the provisions of the IFR. Comments are due within 60 days after the Effective Date.

The IFR consolidates all the executive compensation-related provisions applicable to TARP recipients into a single rule and supersedes all previous Treasury guidance on executive compensation. To the extent Treasury's earlier guidance is inconsistent with the IFR, it is superseded only as of the Effective Date. Moreover, contractual provisions not inconsistent with the EESA or the IFR continue to apply in accordance with their terms.[3] Pursuant to the discretion granted under the EESA, the IFR also incorporates additional guidance.

The IFR applies to any TARP recipient during the period that an obligation to the Federal government remains outstanding. A TARP recipient is defined in section 111(a)(3) of the EESA as "any entity that has received or will receive financial assistance under the financial assistance provided under the TARP." TARP recipients include:

- An entity holding a commitment to receive financial assistance;
- Subsidiaries or parents of a TARP recipient, based on at least a 50% ownership interest (defined by reference to certain provisions of the Internal Revenue Code); and
- An entity related to a TARP recipient, but only if the primary purpose of creating or using that entity is to avoid restrictions under section 111.

Treasury has appointed Kenneth Feinberg, who had previously served as Special Master for the September 11th Victim Compensation Fund, to serve as Special Master for TARP Executive

Compensation. The Special Master will have responsibility for interpreting the executive compensation and governance provisions under the TARP and will have direct oversight over those TARP recipients receiving "exceptional assistance" under certain TARP programs.

The Treasury release of the IFR is 123 pages long and highly detailed and technical. Set forth below is a summary of key provisions of the IFR. A subsequent client alert will provide additional analysis of the operation of the IFR.

Highlights of the IFR

1. Applicability

- The IFR differentiates among three categories of TARP recipients: (1) those receiving "exceptional assistance" (strictest requirements); (2) those holding an "obligation" to the Federal government; and (3) those that never hold an "obligation" (fewest requirements).

  - Recipients of Exceptional Assistance include large institutions that have received assistance over and above that provided under the Capital Purchase Program ("CPP").

  - Recipients that hold an obligation include participants in the CPP, which provides direct capital infusions to the TARP recipient in return for senior preferred shares.

  - Recipients that never hold an obligation include participants in other TARP programs under which the recipient receives financial assistance (*e.g.*, through an asset sale) but has no repayment or repurchase obligation, *e.g.*, the Public-Private Investment Program ("PPIP") and the Unlocking Credit for Small Businesses Program.

- Complex rules govern whether private organizations that participate in the PPIP will be deemed to have received financial assistance and are therefore subject to the IFR.

- Participants in the Term Asset-backed Securities Loan Facility ("TALF") are not subject to the IFR.

- As described below, TARP recipients that never hold an obligation are not subject to the bulk of the compensation provisions.

- The IFR does not apply to TARP recipients that have repaid their obligation, even if warrants are still outstanding.

2. Compensation Restrictions

- The IFR implements the EESA's prohibition on payments of bonuses, retention awards, or incentive compensation ("prohibited compensation"), except for certain long-term stock awards, to senior executives and most highly compensated employees of TARP recipients.

As required by the statute, the number of covered employees varies based on the amount of TARP assistance.

- "Most highly compensated employees" are determined by reference to total compensation for the prior fiscal year calculated using the principles in rules of the Securities and Exchange Commission ("SEC") governing disclosure of compensation to SEOs.

    - Thus, a most highly compensated individual who fell within the rule based on total compensation in 2008 would be prohibited from receiving a bonus in 2009. If, as a result, the individual did not fall within the covered group for 2009 he or she would be eligible to receive in 2010 a bonus based on 2009 income.

    - Partners of partnerships or members of limited liability companies, or similar owners in similar types of entities, are excluded from the definition of "employee" and therefore are not subject to the prohibition, unless the entity is created to avoid the rules.

- The IFR includes complex definitions of prohibited compensation, as well as defining the parameters for permitted long-term stock compensation.

    - The IFR contains an exception to the definition of bonus for commissions based on sales to third parties or assets under management (*e.g.*, brokerage commissions). However, fees earned from sales within an affiliated group, or in incentive compensation in connection with investment banking or proprietary trading are not considered commissions.

– The IFR implements the "grandfather clause" in the EESA for compensation payments made pursuant to a valid written employment contract executed on or before February 11, 2009. The IFR defines a valid written employment contract and rights to payments by reference to specified IRS and SEC regulations.

– The IFR also makes clear that incentive compensation and golden parachute payments paid after enactment of the ARRA but prior to the Effective Date will not be affected by the IFR.

– The IFR implements the EESA's prohibition on golden parachute payments to certain executives and employees of the TARP recipient. It prohibits any payment for the departure from a TARP recipient for any reason. The rule also prohibits "single trigger" provisions that could result in a golden parachute payment upon a change of control that does not result in termination.

- The IFR prohibits tax gross-ups for senior executive officers ("SEOs") and the next 20 most highly compensated employees.

- TARP recipients must disclose and explain the payment of perks over $25,000 to any executive or employee subject to the bonus restrictions.

- The clawback, golden parachute, bonus, say-on pay and other provisions do not apply to TARP recipients that never hold an obligation to Treasury.

    - These TARP recipients are subject to the IFR's requirement for a luxury expenditure policy, as well as some disclosure and more limited certification requirements. They are also prohibited from providing gross-ups to certain of their employees.

3. Implementation and Compliance

- The IFR implements the EESA's requirement that each TARP recipient must establish and maintain a board Compensation Committee comprised entirely of independent directors which must meet at least semi-annually to discuss and evaluate employee compensation plans in light of an assessment of the risk to the TARP recipient posed by such plans. The rules elaborate in detail on the scope, substance and process of the committee's responsibilities to review, discuss and evaluate compensation plans. The Compensation Committee must identify and limit features in SEO compensation plans that could lead SEOs to take unnecessary and excessive risks as well as any features in employee compensation plans that pose risks to the entity.

    - The IFR requires an annual narrative description by the Compensation Committee providing specified substantive information regarding the company's compensation plans and that the Compensation Committee certify to its compliance with the requirements.

    - Compensation Committee disclosures are to be included in the Compensation Committee report in SEC proxy filings for public companies.

    - New disclosures on compensation consultants are required.

    - A non-public TARP recipient that has received $25 million or less in financial assistance may delegate these functions to the board of directors.

- As required by the EESA, the IFR requires each TARP recipient's board of directors to adopt a written policy addressing four categories of "excessive or luxury expenditures" (entertainment or events, office and facility renovations, aviation or other transportation services and other similar items, activities or events). The policy must identify prohibited expenditures and expenditures for which prior approval is required, provide reasonable approval procedures, require executive certifications that approval was properly obtained, require prompt internal reporting of violations, and mandate accountability for adherence to the policy. The policy must be provided to Treasury and to the TARP recipient's primary regulator and posted on its website.

- The TARP Recipient's principal executive officer and principal financial officer are required to certify annually to 15 separate detailed items regarding compliance with the IFR, including with respect to review of compensation plans and efforts to limit risk. The annual certifications, which must also identify the SEOs and the 20 next most highly compensated employees in order of their compensation, are subject to civil and criminal liability for false statements.

4. Authorities of the Special Master

- The Special Master is authorized to interpret section 111, the IFR, and contractual provisions between the Federal government and a TARP recipient. He may also issue a non-binding advisory opinion to any TARP recipient, by request or on his own initiative. The Special Master may decline without explanation a request for an advisory opinion.

- The Special Master is also delegated the authority to examine pre-February 17, 2009 compensation and to negotiate with the TARP recipient and the affected employee if he believes the compensation was contrary to the purposes of TARP or the public interest. He has wide discretion in this regard but must follow a set of principles set out in the IFR regarding how to determine whether compensation was contrary to the purposes of TARP or the public interest. TARP recipients must respond to written requests from the Special Master for information related to these inquiries.

    - Treasury has requested comments on potential procedures and terms under which employees or TARP recipients may reimburse Treasury.

- With respect to a TARP recipient receiving exceptional assistance, the Special Master must approve any bonus payments to covered employees as well as the compensation structures for all the TARP recipient's executive officers and its 100 most highly compensated employees who may not be subject to the bonus limitation.

- Materials submitted to the Special Master and his determinations are subject to disclosure under the Freedom of Information Act after appropriate redaction by the Special Master to protect personal privacy, privileged information, or confidential commercial or financial information.

Conclusions

The IFR raises significant application and interpretive issues. It also continues to raise concerns for TARP recipients who rely on incentive compensation to retain key personnel and for other private entities considering participation in non-CPP TARP programs. We expect a strong response to the request for comments seeking clarification to and modification of a number of the provisions. In the interim, however, TARP recipients will need to review and modify their internal policies and procedures to ensure that they comport with the IFR as issued. TARP recipients with particular issues relating to their compensation programs may wish to consider whether to seek an advisory opinion from the Special Master. They will also need to be prepared to respond carefully to requests for information from the Special Master.

[1] See our February 18, 2009 Alert describing the provisions of the ARRA.

[2] Dept. of the Treasury, TARP Standards for Compensation and Corporate Governance, 31 CFR Part 30, Jun. 10, 2009 (to be published in the FR, Jun. 15, 2009).

[3] Superseded guidance includes Treasury's October 2008 Interim Final Rule, Treasury Notice 2008-PSSFI, Treasury Notice 2008-TAAP, and Treasury's February 4, 2009 executive compensation guidelines.

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