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FINANCIAL INSTITUTIONS DEVELOPMENTS

Congressional Leaders Agree to Eliminate Incentive Compensation and Impose Other Compensation Restrictions for TARP Participants

Leaders of both houses of Congress have reached agreement on an economic stimulus bill that is expected to be signed into law as early as Monday. The compensation-related provisions of the bill are generally similar to the provisions of the Senate bill described in our memorandum of February 11, 2009. However, the revised bill differs from the Senate version in one significant respect: instead of including the Senate bill's annual pay cap on employees of TARP recipients at the amount of compensation provided to the U.S. President, the agreed-upon bill adopts a highly questionable policy of generally prohibiting the payment of any incentive or retention compensation to the top employees of TARP recipients during the period that the Treasury owns TARP preferred stock. Rather than encouraging financial institutions to work towards new variable compensation structures that would enhance incentives of high performers, the new bill would all but eliminate the flexibility to put such incentives in place for the duration of TARP participation. Because the bill does not immediately implement the new requirements but instead requires the Treasury Secretary to adopt rules implementing the limitations, compensation paid by TARP recipients prior to adoption of the new Treasury rules should not be prohibited. However, any compensation paid prior to enactment of the rules will be subject to the rules that the Treasury ultimately does adopt, as well as to the after-the-fact review by Treasury and potential reimbursement described below.

Bonus, Retention and Incentive Prohibitions. The revised bill requires the Treasury Secretary to adopt rules prohibiting any current or future TARP participant from paying any bonus, retention award or incentive compensation to, not only any senior executive officer (defined in the bill as the most highly-compensated executive officers of the institution whose compensation is required to be reported in the summary compensation table), but also to any other employee, without regard to title or management role, who is among the most highly compensated. The size of the affected employee group varies depending upon the amount of the government's TARP investment, but in most larger financial institutions the bill would prohibit bonus payments to at least the twenty most highly compensated employees in addition to the senior executive officers (the Treasury Secretary is authorized expand the number of affected employees). There are very limited exceptions to cover small restricted stock awards (value of not more than one-third of annual compensation, with vesting tied to the duration of the Treasury investment) and bonuses required by written employment contracts entered into on or before February 11, 2009.

The restriction is not limited to officers or managers and thus could cover traders, money managers, investment bankers and other employees who may be responsible for tens if not hundreds of millions of dollars in annual revenues and are paid for their efforts almost exclusively in performance-based compensation – even commissions. It is yet to be determined how much flexibility the Treasury Secretary will have, or be willing to exercise, in promulgating regulations under the bill in order to put reasonable contours around the term "incentive

compensation" so that it does not damage necessary (and what should be non-controversial) existing compensation structures. Moreover, many – a vast majority – of the companies that will be most severely impacted are companies that were strongly encouraged by the U.S. government to accept a Treasury investment under the Capital Purchase Program in the interests of the Nation. While Congress has included a provision that would allow institutions, with the permission of their primary regulator, to pay back TARP investments notwithstanding limits on redemption included in the TARP contracts (*i.e.*, with funds other than those raised through "qualified equity offerings"), in the current environment there is considerable uncertainty as to when institutions will have available sufficient funds or whether regulators will grant permission to redeem the investment. The larger institutions also face "stress testing" pursuant to Treasury's Financial Stability Plan by banking regulators that could actually result in a requirement to further *increase* capital in the near future, including by potentially accepting additional TARP investment. The limitations under the bill leave the stronger TARP recipients with the choice of risking the loss of their top performers and revenue generators to institutions that are not subject to the restrictions and redeeming their preferred with capital that might otherwise be available to consumers and business borrowers.

The preliminary discussions of potential restrictions have largely flown beneath the radar of the media and the financial markets despite the clear risk to the financial industry of value destruction and exportation of management talent to non-U.S. institutions. Some groups, including foreign banks and private firms that entice away the disaffected employees, will profit enormously – but that profit will come at the expense of U.S. public financial institutions whose profitability is essential to the proper functioning of the U.S. credit markets and, ironically, a return to financial stability and the repayment of the TARP investments.

Review of Prior Payments. The bill empowers the Treasury Secretary to review bonuses, retention awards and other compensation paid to the senior executive officers and the next 20 most highly-compensated employees of institutions that were TARP recipients prior to the bill's enactment to determine whether the payments were inconsistent with the TARP or the stimulus bill or otherwise contrary to the public interest. The Treasury Secretary is empowered to negotiate for reimbursement of any compensation or bonuses with the financial institution and the employee.

Other Provisions. The bill also contains the following provisions substantially similar to those included in the Senate bill that was the subject of our memorandum of February 11, which generally modify the limits previously imposed on participants in the Capital Purchase Program and impose some of the restrictions included in the recent extra-CPP one-off assistance initiatives:

- A requirement for current and future TARP recipients to subject the compensation of their executives to a non-binding shareholder "say-on-pay" vote.

- A limitation on compensation that creates incentives for senior executive officers to take unnecessary and excessive risks that threaten the value of the TARP recipient.

- A recovery or "clawback" of any bonus, retention award or incentive compensation paid to senior executive officers and any of the next 20 most highly-compensated

employees of the TARP recipient based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate.

- A prohibition on *any* payments beyond accrued compensation in connection with the departure of any of the ten most highly compensated employees of the TARP recipient for *any* reason.

- A requirement to adopt a company-wide policy regarding excessive or luxury expenditures.

- A prohibition on any compensation plan that would encourage manipulation of the TARP recipient's reported earnings to enhance the compensation of its employees.

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