Cogent Alert

Congress Enacts New Limitations on Executive Pay Under the American Recovery and Reinvestment Act

The American Recovery and Reinvestment Act of 2009 (ARRA) was signed by President Obama on February 17, 2009. The ARRA increases the limitations on executive compensation for institutions participating in the Troubled Assets Relief Program (TARP) under the Emergency Economic Stabilization Act of 2008. The Treasury is expected to communicate the implementation specifics and other details in the coming weeks. **The ARRA provisions apply to institutions that have received or will receive financial assistance through the TARP.**

The expanded legislation touches several key areas including:

- A requirement to allow shareholders a nonbinding vote on executive compensation ("Say on Pay") effective for proxies filed after February 17, 2009
- The elimination of severance payments for senior executives
- The elimination of incentive compensation for senior executives

Of interest is the fact that the Senate pushed the timing for implementation of the "Say on Pay" requirement to be effective immediately, even though details were not fully vetted.

The next section summarizes the executive compensation provisions of the ARRA, followed by Cogent Compensation Partners' observations about these provisions and the potential implications on executive compensation in the future.

Expansion of Executive Compensation Limitations

The following table outlines the ARRA provisions applicable to institutions with outstanding financial obligations provided under the TARP.

Provision	Comments
Requires "Say on Pay" shareholder vote	• Filers must submit separate nonbinding shareholder vote to approve compensation of executives • Effective immediately for companies filing proxies after February 17, 2009
Prohibits Golden Parachute payments	• Applies to Senior Executive Officers* (SEOs) and the next 5 most highly-compensated employees • "Golden Parachute" terminology refers to any severance payment – not just change-in-control severance

	• Includes any payment to an SEO upon departure for any reason, except for services performed or benefits accrued

Prohibits bonuses, retention awards, or incentive compensation; allows for grants of restricted stock in limited amounts	• Prohibits incentive compensation to certain numbers of senior executives depending on the level of assistance:
	  • Less than $25,000,000, applies to most highly compensated employee
	  • At least $25,000,000 but less than $250,000,000, applies to 5 most highly-compensated employees
	  • At least $250,000,000 but less than $500,000,000, applies to SEOs and the next 10 most highly-compensated employees
	  • Equal to $500,000,000 or more, applies to the SEOs and the next 20 most highly-compensated employees
	• Allows for grants of restricted stock
	  • Value cannot exceed one-third of the total amount of employee's annual compensation
	  • Cannot fully vest during period receiving aid
	• Exemption if bonus payments paid pursuant to a contractual agreement entered into on or before February 11, 2009

Excludes incentives for taking "unnecessary and excessive risk"	• Limits incentives for SEOs that motivate "unnecessary and excessive risks" which threaten the institution's value
Requires clawback of bonus, retention award, or other incentive compensation	• Applies to SEOs and the next 20 most highly-compensated employees • Bonuses, retention awards, or other incentive compensation may be recovered for disclosure of financial information found to be materially inaccurate
Prohibits compensation plans that encourage manipulation of earnings	• Compensation plans that would encourage the manipulation of reported earnings to enhance the compensation of an employee are prohibited
Requires Compensation Committee to administer	• Board Compensation Committee must be in place for the review of compensation plans • The Committee must be comprised of independent directors and meet at least semi-annually to discuss compensation plans and assess any risk posed by such plans • Note: Independent director requirement generally exists under stock exchange listing and other IRS and SEC rules
Requires Certification of Compliance	• The CEO and CFO must certify in writing compliance with the legislation • Public companies must file the certification with the SEC • Private companies must file with the Secretary of the Treasury
Limits luxury expenditures	• Board of directors must establish a company-wide policy against "excessive or luxury expenditures" • Identified luxury expenditures include: • Entertainment or events

	• Office and facility renovations • Aviation or other transportation services • "Other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of business operations"
Subjects prior incentive payments to review	• Bonuses and retention awards of SEOs and next 20 most highly-compensated employees subject to review by the Secretary of the Treasury • If deemed inconsistent with purposes of ARRA or the TARP, ARRA requires the Secretary to engage in negotiations for appropriate reimbursements to the federal government

*Senior Executive Officer is defined as "an individual who is one of the top five most highly paid executives of a public company, whose compensation is required to be disclosed."

Cogent Observations

While the law is clearly intended to apply to institutions participating in the ARRA (and TARP), some common themes are arising from the legislation that could influence executive compensation practices in the broader market:

1. **"Say on Pay"**
   This legislation requires institutions to submit executive compensation programs to shareholders for a nonbinding vote. Further details are to be worked out by the SEC. Many believe that the details of the shareholder "Say on Pay" provisions will be readily applicable to the broad public company market, making legislation requiring such a vote soon to follow.

2. **Severance Arrangements**
   The legislation prohibits severance payments to executives of participating institutions. Interestingly, it refers to any executive severance payment as a "golden parachute." This is an historically technical term in the Internal Revenue Code used to describe a payment related to a change in control. This legislation essentially extends the definition of the term, begging the question if it opens the door to a broader application of tax penalties to severance payments in general. In addition, proxy advisory groups are putting serious pressure on compensation committees that adopt severance arrangements which include Golden Parachute excise tax gross-ups. The external focus on severance arrangements will continue to press companies to evaluate their executive severance arrangements and confirm the business purpose of such arrangements.

3. **Incentive Compensation**
   This law prohibits participating institutions from paying senior executives incentive compensation. Interestingly, the limits apply to the senior-most executives but not to lower level managers. This approach significantly distances the compensation systems of senior executives from the other managers. In addition, the philosophical position seems to presume that incentive pay motivates managers to take excessive risk. This debate will likely spread to various forums, even outside the realm of this legislation. For many years, incentive compensation systems have been widely accepted as motivating managers to higher levels of performance. Having to defend such a fundamental capitalist concept never occurred to most of us.

4. **Restricted Stock**

The bill allows for the granting of restricted stock as the only permissible incentive compensation, in amounts not to exceed one-third of the executive's annual compensation. This extreme overweighting to short-term compensation flies in the face of historical executive compensation theory that long-term incentives should outweigh annual compensation. The purpose of overweighting compensation to long-term incentives has historically served to motivate management to focus on long-term value of the company over short-term results.

For more information please see the American Recovery and Reinvestment Act of 2009 on the White House website: http://www.whitehouse.gov/the_press_office/arra_public_review/

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About Cogent Compensation Partners

Cogent Compensation Partners is a leading provider of objective and expert advice on the subject of executive compensation, corporate governance, and the linkage between company performance and executive pay.

Our executive compensation consultants assist in driving together the various interests involved in the executive pay debate: employees, shareholders, institutions, and other stakeholders. Our services include compensation committee advisory, incentive plan design, compensation strategy development, board of director compensation analysis, executive compensation related shareholder proposal assistance and stock ownership guidelines development.

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