

**EXECUTIVE COMPENSATION AND RISK: TARP
RULES FOR FINANCIAL INSTITUTIONS TRIGGER
BROADER RISK ASSESSMENT OF
COMPENSATION POLICIES**

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I. INTRODUCTION

The world of executive compensation will never be the same for financial institutions after 2009. In fact, due to the crisis in the world's financial markets in 2009, the world of executive compensation most likely will never be the same for any publicly traded corporation. Looking for a scapegoat for the near collapse in the world's financial markets, many in the government and media (both in the U.S. and Europe), sought to blame the compensation policies of financial institutions. Therefore, limitations and restrictions on executive compensation became a central part of the legislation proposed and adopted in response to the financial crisis.

This Article will focus on the new requirement that companies assess their executive compensation plans and agreements to determine whether they encourage excessive risk taking. The Emergency Economic Stabilization Act (EESA),¹ signed into law by President Bush on October 3, 2008, first created this requirement for financial institutions that received federal funds under the Troubled Assets Relief Program (TARP). Thereafter, the American Recovery and Reinvestment Act (ARRA),² signed into law by President Obama on February 17, 2009, included amendments to the executive compensation

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1. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

2. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115 (2009).

provisions of the EESA. Next an Interim Final Rule interpreting Section 111 of the EESA was published by the Treasury Department in the Federal Register on June 15, 2009.³

While the EESA imposed executive compensation limits on financial institutions that are recipients of TARP funds, on October 27, 2009 the Federal Reserve Board (Fed) issued Proposed Guidance on Sound Incentive Compensation Policies (Guidance) that is designed to effect all financial institutions.⁴ The Fed's requirements so far are only a proposal but outline key requirements that could be a mainstay even after financial institutions have exited TARP.

The influence of the executive compensation provisions affecting financial institutions receiving TARP funds were further extended on December 15, 2009, when the U.S. Securities and Exchange Commission (SEC) issued a new Final Rule on executive compensation disclosure and corporate governance that applies risk assessment requirements similar to those under TARP to all publicly traded companies, beginning in 2010.⁵ The SEC's Final Rule requires all public companies to assess their compensation policies and practices to determine if they are reasonably likely to have a material adverse effect on the institution. This Article will examine the process that companies should employ to assess properly the risk associated with executive compensation.

One of the primary reasons TARP recipients such as Citigroup and Bank of America have sought to pay back their share of funds received is to escape the executive compensation limits imposed by the EESA.⁶ For Bank of America in particular the limitations on executive compensation were a hindrance in its ability to find a new CEO.⁷ In order to attract top quality

3. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. 28,394 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30).

4. Proposed Guidance on Sound Incentive Compensation Policies, 74 Fed. Reg. 55,227 (Oct. 27, 2009) [hereinafter Sound Incentive Compensation].

5. Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334 (Dec. 23, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249 and 274).

6. *BofA Repays All of Government Bailout Funds*, MSNBC.COM, Dec. 10, 2009, http://www.msnbc.msn.com/id/34350133/ns/business-us_business/.

7. *Id.*

candidates Bank of America needed to escape the limitations and meddling of regulators. Newly proposed legislation and the Guidance could prove to make the repayment of TARP funds only a temporary solution, as new legislation could place all publicly traded corporations under executive compensation limitations.

Part II of this article will discuss the limitations on executive compensation imposed by the EESA for financial institutions that receive TARP funds.⁸ Part III is a discussion of the Fed's Guidance on incentive compensation policies for all financial institutions.⁹ Part IV sets forth the SEC rules on executive compensation and corporate governance that apply to all public companies.¹⁰ Part V provides a look at other proposed executive compensation legislation and the limitations being considered.¹¹ Part VI will offer a discussion on executive compensation risk assessment and provides an overview of key considerations and procedures necessary to ensure that an accurate and proper assessment is conducted.¹²

II. THE LIMITATIONS ON EXECUTIVE COMPENSATION AT FINANCIAL INSTITUTIONS RECEIVING TARP FUNDS

Section 111 of EESA, as amended by ARRA,¹³ imposed a variety of new limitations and restrictions on the executive compensation plans and arrangements of any entity that received financial assistance under TARP. These restrictions and standards apply throughout the period during which any obligation arising from financial assistance provided under TARP remains outstanding (TARP obligation period).

8. *See infra* Part II, pp. 61-70.

9. *See infra* Part III, pp. 70-78.

10. *See infra* Part IV, pp. 78-88.

11. *See infra* Part V, pp. 88-91.

12. *See infra* Part VI, pp. 91-101.

13. 12 U.S.C. § 5221 (2010).

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A. *Prohibition on Executive Compensation Programs that Create Excessive Risk*

EESA Section 111(b)(3) requires that each TARP recipient meet appropriate standards for executive compensation and corporate governance, including:

Limits on compensation that exclude incentives for senior executive officers of the TARP recipient to take unnecessary and excessive risks that threaten the value of such recipient during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding.¹⁴

The term “senior executive officer” (SEO) 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 pursuant to the Securities Exchange Act of 1934, and any regulations issued thereunder, and non-public company counterparts.”¹⁵

B. *Prohibition on Compensation Plans that Encourage Manipulation of Earnings*

Closely related to the limits on compensation incentives for risk taking by SEOs, is a provision that prohibits TARP recipients from maintaining “any compensation plan that would encourage manipulation of the reported earnings of such TARP recipient to enhance the compensation of any of its employees.”¹⁶ This prohibition applies to all employees, including those below the SEO level.

14. American Recovery and Reinvestment Act, § 7001, 123 Stat. at 517.

15. *Id.*

16. *Id.* at 518-19.

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C. Compensation Committee Composed of Independent Directors

Publicly traded TARP recipients must establish a Compensation Committee of the board of directors, for reviewing employee compensation plans, comprised entirely of independent directors.¹⁷ TARP requires this Committee to “meet at least semiannually to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to the TARP recipient by such plans.”¹⁸ Most publicly traded companies already have structured their compensation committee to satisfy the “outside director” requirements of Section 162(m) of the Internal Revenue Code of 1986,¹⁹ as amended (Code), the independence requirements of Section 16(b) of the Securities Exchange Act of 1934²⁰ (Exchange Act), and the director independence requirements of the individual stock exchanges.

In the case of TARP recipients that are not publicly traded and that have not received in excess of \$25,000,000 of financial assistance through TARP, the company’s board of directors must carry out the duties of the Compensation Committee outlined above.²¹

D. Recovery of any Compensation Paid Based on Inaccurate Financial Information

ARRA requires TARP recipients to implement “clawback” provisions to recover bonuses, retention awards, or incentive compensation paid to any CEO or any of the next twenty most highly compensated employees based on statements of earnings, revenues, gains, or other criteria that are later found to

17. *Id.* at 519.

18. *Id.*

19. Internal Revenue Code, 26 U.S.C. § 162(m) (2006).

20. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006).

21. American Recovery and Reinvestment Act, § 7001, 123 Stat. at 519.

be materially inaccurate.²² The Sarbanes-Oxley Act imposed narrower clawback provisions back in 2002.²³

E. Prohibition on “Golden Parachute Payments”

TARP prohibits affected institutions from making “golden parachute payments,” or severance payments, to a CEO or any of the next five most highly compensated employees during the TARP obligation period.²⁴ Importantly, the EESA and ARRA expand the original definition of the term “golden parachute payment” to include “any payment to a senior executive officer upon departure from a company for any reason, except for payments for services performed or benefits accrued.”²⁵

F. Prohibition on Bonus, Retention Award, or Incentive Compensation

ARRA prohibits TARP recipients from paying or accruing any bonus, retention award, or incentive compensation during the TARP obligation period.²⁶ However, this prohibition provides an exception for the payment of long-term restricted stock by the TARP recipient, provided that such long-term restricted stock (i) does not fully vest during the TARP obligation period; (ii) has a value that does not exceed one third of the receiving employee’s total annual compensation; and (iii) is subject to such other terms and conditions as the Secretary of the Treasury may determine is

22. *Id.* at 517.

23. Sarbanes-Oxley Act, 15 U.S.C. § 7243 (2006) (If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for--

“(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.”).

24. American Recovery and Reinvestment Act, § 7001, 123 Stat. at 517.

25. *Id.*

26. *Id.* at 518.

in the public interest.²⁷ Because of this prohibition, most TARP recipients have increased base salary and maximum restricted stock awards to match approximately the level of compensation the institution paid to affected CEOs before the TARP limitations applied.

The scope of this prohibition on bonus, retention award, or incentive compensation depends on the amount of financial assistance that a TARP recipient received. For any institution that received less than \$25,000,000 under TARP, the prohibition is limited to the most highly compensated employee of that institution.²⁸ However, with respect to an institution that received TARP assistance of \$500,000,000 or more, the prohibition on bonus, retention award, or incentive compensation applies to all the CEOs and the next twenty most highly-compensated employees,²⁹ or such higher number of employees as the Secretary of the Treasury may determine is in the public interest with respect to the TARP recipient.³⁰

ARRA provides an exemption from the prohibition outlined above for any “bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009,” which the Secretary of the Treasury determines to be valid.³¹

G. *Limitation on “Luxury” Expenditures*

TARP requires the board of directors of TARP recipients to establish a company-wide policy regarding excessive or luxury expenditures.³² Under TARP, this policy should include excessive expenditures on:

- (a) entertainment or events;
- (b) office and facility renovations;

27. *Id.*

28. *Id.*

29. *Id.*

30. American Recovery and Reinvestment Act, § 7001, 123 Stat. at 518..

31. *Id.*

32. *Id.* at 519.

(c) aviation or other transportation services; or
(d) other activities or events that are not reasonable expenditures for conferences, staff development, reasonable performance incentives, or other similar measures conducted in the normal course of the company's business operations.³³

The Interim Final Rule requires the board of directors of a TARP recipient to provide its excessive or luxury expenditures policy to the Treasury, its primary regulatory agency, and post the text of the policy on its website.³⁴

H. *Say on Pay*

Any proxy or consent for a shareholder meeting of a TARP recipient during the TARP obligation period must permit a separate shareholder vote to approve the compensation of executives, as disclosed under the SEC compensation disclosure rules.³⁵ This shareholder vote will not be binding on the company's board of directors, will not be construed as overruling a decision by the board, and will not create or imply any additional fiduciary duty of the board.³⁶ However, some institutional investor advisory services have stated that they will vote against the board of directors of any company that ignores a shareholder resolution that receives majority support.

ARRA required the SEC to promulgate a final rule regarding this provision within one year of the date of enactment. On February 26, 2009, the SEC issued preliminary guidance indicating that the provision calls for a shareholder vote on executive compensation.³⁷ "A shareholder proposal on "say on pay" that only asks the company to adopt a policy providing for annual shareholder votes on executive compensation in the future

33. *Id.*

34. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. at 28,417.

35. American Recovery and Reinvestment Act, § 7001, 123 Stat. at 519.

36. *Id.*

37. SEC, *American Recovery and Reinvestment Act of 2009*, Feb. 26, 2009, <http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm>.

would not satisfy this requirement.”³⁸ The ARRA requires an actual, non-binding vote by the shareholders to approve executive compensation.³⁹ The SEC’s preliminary guidance also provided that despite the clarity of the language “shall permit,” ARRA “does not condition the requirement for a vote on the receipt of a shareholder proposal on approving executive compensation.”⁴⁰ The law is intended to provide shareholders with a yearly vote to approve the compensation of executives.⁴¹

I. Limit on Deductibility of Compensation

TARP amends Code section 162(m)(5) to impose a \$500,000 cap on the deductibility of annual compensation for each CEO of a TARP recipient.⁴² While this limit technically applies only during the TARP obligation period, it also limits the deductibility of deferred compensation paid to a CEO in a future year, where the compensation is paid in a year not subject to the TARP limits but was earned during a year in which the TARP limits were in place. Additionally, the new definition eliminates the exception for performance-based compensation, which is contrary to everything that proponents of good corporate governance have worked for since 2004.

J. Required Review of Prior Payments to Executives

ARRA requires that the Secretary of the Treasury review “bonuses, retention awards, and other compensation paid to the senior executive officers and the next 20 most highly-compensated employees of each entity receiving TARP assistance before the date of enactment of the [ARRA], to determine whether any such payments were inconsistent with the purposes of this section or the TARP or were otherwise contrary to the public interest.”⁴³ ARRA further requires that, if the Secretary determines that any

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. American Recovery and Reinvestment Act, § 7001, 123 Stat. at 517.

43. *Id.* at 520.

such payments were inconsistent with the purposes of this section or the TARP or were otherwise contrary to the public interest, the Secretary of the Treasury must engage in negotiations with the TARP recipient and the receiving employee for reimbursements to the federal government regarding the compensation or bonuses.⁴⁴

The Interim Final Rule seems to limit this requirement to employees of TARP recipients receiving exceptional financial assistance. Providing that for any period during which a TARP recipient is designated as having received exceptional financial assistance, the TARP recipient must gain the approval of the Special Master for all compensation payments to, and compensation structures for, CEOs, executive officers (as defined under the Securities and Exchange Act, Rule 3b-7), and the 100 most highly compensated employees.⁴⁵

K. CEO and CFO Certification Requirements

ARRA requires the CEO and CFO (or their equivalents) of a TARP recipient to provide a written certification of compliance with the foregoing requirements.⁴⁶ Publicly traded companies must file these certifications with the SEC along with annual filings required under securities laws.⁴⁷ Private companies are required to file their certifications with the Secretary of the Treasury.⁴⁸

L. Perquisite Disclosure

During the TARP period, a TARP recipient must disclose annually any perquisite whose total value for the TARP recipient's fiscal year exceeds \$25,000 for each of the CEOs and a specified number of other highly compensated employees, with the number of affected employees based on the amount of assistance

44. *Id.*

45. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. at 28,416.

46. American Recovery and Reinvestment Act, § 7001, 123 Stat. at 519.

47. *Id.*

48. *Id.*

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received.⁴⁹ Within 120 days of the completion of a fiscal year any part of which is a TARP period, the TARP recipient must provide the Treasury Department and its primary regulatory agency with a narrative description of the amount and nature of these perquisites, the recipient of these perquisites, and a justification for offering these perquisites including a perquisite offered with a value that does not exceed \$25,000.⁵⁰

M. Compensation Consultant Disclosure

TARP requires the compensation committee of the board of directors of the TARP recipient to provide annually a narrative description of whether the TARP recipient, the board of directors, or the compensation committee of the board has engaged a compensation consultant.⁵¹ The narrative must provide a description of “all types of services, including non-compensation related services, the compensation consultant or any of its affiliates has provided to the TARP recipient, the board, or the compensation committee during the past three years, including any ‘benchmarking’ or comparisons employed to identify certain percentile levels of compensation.”⁵² For example, the TARP recipient must identify the entities used for benchmarking and provide a justification for using those entities and a justification for the lowest percentile level proposed for compensation.⁵³ The TARP recipient must provide this disclosure to the Treasury and to its primary regulatory agency within 120 days of the completion of a fiscal year, any part of which is a TARP period.⁵⁴

N. Prohibition on Gross-Up Payments

“TARP recipients are prohibited from providing (formally or informally) tax gross-ups to any of the CEOs and next twenty

49. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. at 28,417.

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

most highly compensated employees during the TARP period,” except in extremely limited circumstances.⁵⁵ The Interim Final Rule clarifies that the term “gross-up” means any reimbursement of taxes owed with respect to any compensation (other than a payment under a tax equalization agreement to take into account foreign taxes).⁵⁶ The prohibition on gross-ups includes a right to a payment of such a gross-up at a future date, even if it is after the TARP period.⁵⁷

III. FEDERAL BANK REGULATORY AGENCIES AND RISK ASSESSMENT OF COMPENSATION

A. *The Fed’s Proposed Guidance on Sound Incentive Compensation*

On October 27, 2009, the Fed issued its Guidance on incentive compensation in an effort to ensure that the use of incentive compensation at financial institutions does not encourage excessive risk taking and run contrary to the safety and soundness of the company.⁵⁸ Financial institutions have too often rewarded employees for increasing short-term profits or revenues without paying attention to the risks that the activities that generate such returns pose to the company.⁵⁹ Incentivized compensation arrangements often pressure employees to take risks that are beyond the company’s tolerance.⁶⁰ Furthermore, the discouragement of such behavior cannot always be left to the shareholders because too often they are willing to tolerate unsafe amounts of risk for the prospect of financial reward.⁶¹ As a result,

55. TARP Standards for Compensation and Corporate Governance, 74 Fed. Reg. at 28,417.

56. *Id.* at 28,409.

57. *Id.* at 28,417.

58. Sound Incentive Compensation, *supra* note 4. The Fed’s proposed policy applies to “banking organizations,” which it defines as “U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency, or commercial lending company in the United States. *Id.* at 55,231 n.1.

59. *Id.* at 55,227.

60. *Id.* at 55,228.

61. *Id.*

the Fed has decided that it must institute guidance that will help protect the safety and soundness of a financial institution, and to take an active supervisory role in seeing to it that proper compensation arrangements are implemented.⁶² There are three key principles to the Fed's Guidance: "(i) provide employees incentives that do not encourage excessive risk taking beyond the organization's ability to effectively identify and manage risk; (ii) be compatible with effective controls and risk management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors."⁶³

1. Balanced Risk-Taking Incentives

An incentive compensation arrangement is balanced when it takes into account the risks and the benefits of employee activities that may trigger such incentives and weighs those against the safety and soundness of the company.⁶⁴ Under this approach, two employees who generate the same amount of revenue or profit should not receive the same amount of incentive compensation; rather the employee whose activities were riskier should receive less.⁶⁵ In order to develop a proper balance, financial institutions must consider the full range of risks including credit, market, liquidity, operational, legal, compliance, and reputational.⁶⁶ Further, the consideration should be for all current and potential risks, including the cost and amount of capital that may be necessary in preserving the safety and soundness of the company.⁶⁷ In order to maintain balanced incentive compensation arrangements, financial institutions must modify the arrangement as needed.⁶⁸

Currently, there are four methods for making compensation more sensitive to risk. One is that awards should be risk-adjusted, meaning that financial awards should be adjusted

62. *Id.*

63. *Id.*

64. Sound Incentive Compensation, *supra* note 4 at 52,232.

65. *Id.*

66. *Id.* at 55,233.

67. *Id.* at 55,233.

68. *Id.*

based on the risk the employee's activities create.⁶⁹ There is also the use of deferral payments, which delays the actual payout of an award to the employee to take into account the losses or other outcomes of the risk associated activities that are not always clear until much later.⁷⁰ Longer performance periods are an alternative and, similar to the use of deferral payments, allow for the risks to materialize before the payment of an award.⁷¹ The fourth approach currently is to reduce the amount by which an award increases as an employee achieves higher and higher performance thresholds.⁷²

A financial institution must further tailor its approach for achieving balanced incentive compensation to account for the differences between employees.⁷³ For example, the same incentive structure will not be applicable to an executive and to a non-executive employee, and there may be differences between executives and between non-executive employees.⁷⁴ Also required under the Guidance is the careful consideration of "golden parachutes" and "golden handshakes" because the use of such incentives can often lead to excessive risk taking activities that impact the safety and soundness of the company.⁷⁵ Finally, any and all approaches a financial institution implements to balance incentive compensation with risk must be disclosed to the employees so that they are aware of the ways risk is taken into account in determining their incentive compensation.⁷⁶

2. Compatibility With Effective Controls and Risk Management

The Guidance calls for all financial institutions to establish risk management processes and the proper internal controls to ensure that balanced compensation arrangements are being

69. *Id.*

70. Sound Incentive Compensation, *supra* note 4 at 55,233.

71. *Id.* at 55,234.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. Sound Incentive Compensation, *supra* note 4 at 55,235.

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implemented.⁷⁷ There will no doubt be employees who try to evade the processes, and therefore, financial institutions should conduct regular internal reviews to make sure that the processes and controls in place are being followed.⁷⁸ However, in order for this all to work, the financial institution must put into place the appropriate personnel to oversee the processes and compensation arrangements. The risk management personnel must have an understanding of the risks and potential outcomes of employee activities.⁷⁹ To retain the proper personnel that have the skills and experience necessary to fulfill the risk management role, the compensation arrangements for such personnel themselves must be sufficient.⁸⁰ Finally, at all times the processes and controls must be monitored and revised as needed to ensure that compensation arrangements are balanced.⁸¹

3. Strong Corporate Governance

The third principle in the Guidance calls for maintaining strong corporate governance. This requires that the board of directors of each financial institution play an active role in the oversight of the incentive compensation arrangements.⁸² The Guidance places the ultimate burden upon the board to make sure that compensation arrangements are balanced and do not put the company's safety and soundness at risk.⁸³ Additionally, the Guidance suggests that the board directly approve the compensation arrangements for any senior executives due to the fact that senior executives themselves will be actively involved in the risk management process.⁸⁴

The board is also responsible for monitoring the performance and design of the compensation arrangements.⁸⁵ This

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.* at 55,236.

81. *Id.*

82. Sound Incentive Compensation, *supra* note 4 at 55,236.

83. *Id.*

84. *Id.*

85. *Id.*

will require the board to receive data and analysis regarding the compensation arrangements regularly, and to evaluate the information on a forward-looking basis as well as backward-looking basis.⁸⁶ The board may want to consider establishing a committee of non-executive directors that is responsible for overseeing the compensation arrangements and reporting them to the entire board.⁸⁷ Additionally, the board should be given the ability to hire a third-party consultant to help it make sure that the compensation arrangements are in line with the safety and soundness of the company.⁸⁸ To provide oversight over the board's functions the financial institution must disclose certain amounts of information regarding compensation arrangements and the risk management process to shareholders, so that they may be able to take appropriate actions as necessary.⁸⁹ The Guidance also points out that large, complex financial institutions should follow a systemic approach with formal policies, procedures, and systems in order to ensure compensation arrangements are balanced and consistent with safety and soundness.⁹⁰

4. Supervisory Initiatives

The Fed is also proposing to play a supervisory role in the implementation of safe and sound incentive compensation arrangements by financial institutions.⁹¹ The two initiatives are to develop “(i) a special horizontal review of incentive compensation practices at large complex banking organizations (LCBOs); and (ii) a review of incentive compensation practices at other banking organizations as part of the risk-focused examination process for these organizations.”⁹²

86. *Id.*

87. *Id.*

88. Sound Incentive Compensation, *supra* note 4 at 55,236.

89. *Id.*

90. *Id.*

91. *Id.* at 55,229.

92. *Id.*

a. LCBOs

LCBOs are of particular importance because they are the most likely to use incentive compensation arrangements and the most likely to effect the broader financial system.⁹³ Each LCBO, therefore, will be required to submit certain information and documentation to the Fed describing the financial institution's current incentive compensation practices and future plans for improving such practices.⁹⁴ Thereafter, the Fed will work individually with each company to ensure that the company has balanced incentive compensation arrangements.⁹⁵ The overall purpose of the in-depth supervision of LCBOs is to (i) understand the current practices and plans for improving the balance of incentive compensation arrangements; (ii) assess the strength of certain controls; (iii) understand the role of the board of directors and other risk management personnel; and (iv) identify emerging best practices.⁹⁶ The Fed also reserves the right to take supervisory action if the financial institution fails to develop, submit, or adhere to a plan designed to prevent excessive risk-taking.⁹⁷

b. Community and Regional Banking Organizations

Community and regional banking organizations will not be overseen as extensively as the LCBOs. Rather the review of their incentive compensation arrangements will be conducted as part of the risk-management reviews normally conducted.⁹⁸ The reviews will also be tailored to fit the scope and complexity of the financial institution.⁹⁹ For example, small financial institutions will not be required to have the same formalized approaches as larger financial institutions.¹⁰⁰ Regardless, the Fed maintains the right to take enforcement action if the incentive compensation

93. *Id.*

94. Sound Incentive Compensation, *supra* note 4 at 55,229.

95. *Id.*

96. *Id.* at 55,238.

97. *Id.*

98. *Id.* at 55,229.

99. *Id.*

100. Sound Incentive Compensation, *supra* note 4 at 55,238.

arrangements pose a threat to the safety and soundness of the company.¹⁰¹

B. The FDIC's Advance Notice of Proposed Rulemaking on Incorporating Employee Compensation Criteria into the Risk-Based Assessment System for Deposit Insurance

On January 12, 2010, the Federal Deposit Insurance Corporation issued an advance notice of proposed rulemaking (ANPR) on "Incorporating Employee Compensation Criteria Into The Risk Assessment System."¹⁰² Through the ANPR, the FDIC is seeking to identify criteria upon which to base adjustments to the risk-based assessment system in order to correctly price and assess the risks presented by certain compensation programs. The FDIC would organize these criteria to provide either a "meets" or "does not meet" metric, which it then would use to adjust an institution's risk-based assessment rate.¹⁰³

While stating that the FDIC "does not seek to impose a ceiling on the level of compensation that institutions may pay their employees," the proposed rulemaking indicates that compensation programs that meet the FDIC's goals may include the following features:

- A significant portion of compensation for employees whose business activities can present significant risk to the institution and who receive a portion of their compensation according to formulas based on meeting performance goals should be comprised of restricted, non-discounted company stock. Restricted, non-discounted company stock would be stock that becomes available to the employee at intervals over a period of years. The stock would be awarded at the closing

101. *Id.* at 55,229.

102. Incorporating Employee Compensation Criteria Into the Risk Assessment System, 75 Fed. Reg. 2,823 (Jan. 19, 2010) (to be codified at 12 C.F.R. pt. 327).

103. *Id.* at 2,825.

- price in effect on the day of the award.
- Significant awards of company stock should become vested over a multi-year period and should be subject to a look-back mechanism (*e.g.*, clawback) designed to account for the outcome of risks assumed in earlier periods.
 - The compensation program should be administered by a committee of the Board composed of independent directors with input from independent compensation professionals.¹⁰⁴

The ANPR adds that:

Under the approach contemplated above, the FDIC could conclude that firms that are able to attest that their compensation programs include each of the features listed above present a decreased risk to the DIF, and therefore would face a lower risk-based assessment rate than those firms that could not make such attestation. Alternatively, the FDIC could conclude that firms that cannot attest that their compensation programs include each of these features present an increased risk to the DIF, and therefore would face a higher risk-based assessment rate than those firms that do make such attestation.¹⁰⁵

The deadline for comments on the ANPR is thirty days after publication in the federal register. After receiving comments, the FDIC presumably will consider the comments and issue new final rules before the end of 2010. Thereafter, FDIC insured institutions would have one more regulator examining its executive compensation programs and expressing its opinion.

104. *Id.*

105. *Id.*

IV. SEC RULES ON EXECUTIVE COMPENSATION INCORPORATE
PROVISIONS FROM TARP

On December 16, 2009, the SEC published a new Final Rule on executive compensation disclosure and corporate governance (the “Final Rule”), with an effective date of February 28, 2010.¹⁰⁶ The new Final Rule covers several separate subjects, including a few that originated in TARP. Due to ambiguities in the effective date provisions of the Final Rule, the SEC issued transition guidance on the Final Rules, in Question & Answer form, on December 22, 2009, applicable “to the filing of proxy statements, Form 10-Ks, Form 8-Ks, Securities Act registration statements, and Exchange Act registration statements at or around the time of the effective date.”¹⁰⁷

The most important clarification is that companies with a fiscal year end before December 20, 2009, will not have to comply with the new Final Rule in 2010, even if the company does not file its 2009 Form 10-K and related proxy statement until after February 28, 2010.¹⁰⁸ A company with a fiscal year ended on or after December 20, 2009, will be required to comply, unless the definitive proxy materials and the Form 10-K are filed before February 28, 2010.¹⁰⁹

A. *Disclosure of the Company’s Compensation Policies and Practices as they Relate to the Company’s Risk Management*

The Final Rule includes a requirement for assessing whether the company’s executive compensation plans encourage risk taking. However, the Final Rule modifies the requirement of EESA Section 111(b)(3) in a manner that should lessen the burden imposed on reporting companies not subject to TARP.¹¹⁰

“The [F]inal [R]ule requires a company to address its compensation policies and practices for all employees, including

106. Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334.

107. SEC, *Proxy Disclosure Enhancement Transition*, Dec. 22, 2009, <http://www.sec.gov/divisions/corpfin/guidance/pdetinterp.htm>.

108. *Id.*

109. *Id.*

110. *See* Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,362.

non-executive officers, if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company.”¹¹¹ The “reasonably likely” disclosure threshold would parallel the Management Discussion and Analysis requirement, “which requires risk-oriented disclosure of known trends and uncertainties that are material to the business.”¹¹² By focusing on risks that are “reasonably likely” to have a material adverse effect on the company, the SEC hopes the Final Rule will only bring forth disclosures about incentives in the company’s compensation policies that are most relevant to investors, rather than burdening them with potentially insignificant and unnecessarily speculative information.¹¹³ The Final Rule also allows companies to consider compensating or offsetting steps or controls designed to limit the risk of executive compensation agreements.¹¹⁴ “If a company has compensation policies and practices for different groups that mitigate or balance incentives, these could be considered in deciding whether risks arising from the company’s compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company as a whole.”¹¹⁵

Perhaps most importantly, the new disclosure requirements will not be a part of the Compensation Discussion and Analysis (CD&A).¹¹⁶ The SEC moved the new requirements into a separate paragraph in Item 402 of Regulation S-K, agreeing with commenters who asserted that it would be confusing to expand the CD&A, beyond the named executive officers, to include disclosure compensation policies for all employees.¹¹⁷ Smaller reporting companies will not be required to provide the new disclosure, even

111. *Id.* at 68,336 (The proposed rules would have required discussion and analysis of compensation policies if risks arising from those compensation policies “may have a material effect on the company”).

112. *Id.* (citing to Item 303 of Regulation S-K [17 CFR 229.303]).

113. *Id.* (The Final Rule also refers to a material “adverse” effect on the company, as opposed to any “material effect” as proposed).

114. *Id.* at 68,336-37.

115. *Id.*

116. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,337.

117. *Id.* (Note also that a separate provision of the Final Rule requires a discussion of the board’s role in risk oversight see § 229.407(h) (Item 407)).

though it is not a part of the CD&A.¹¹⁸ Additionally, “the [F]inal [R]ule does not require a company to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company.”¹¹⁹

The Final Rule contains a “non-exclusive list” of situations where compensation arrangements have the potential to create material risk for a company, and examples of the types of issues that could raise discussions.¹²⁰ This list includes compensation policies and practices:

- At a business unit of the company that carries a significant portion of the company’s risk profile;
- At a business unit with compensation structured significantly differently than other units within the company;
- At a business unit that is significantly more profitable than others within the company;
- At a business unit where the compensation expense is a significant percentage of the unit’s revenues; and
- That vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period.¹²¹

Although the Final Rule only requires disclosure if the compensation policies create risks that are reasonably likely to have a material adverse effect on the company, as we learned from

118. *Id.* (Smaller reporting companies are permitted to provide the scaled disclosures specified in Items 402(l) through (r) of Regulation S-K, rather than the disclosure specified in Items 402(a) through (k) of Regulation S-K).

119. *Id.* at 68,338.

120. *Id.* at 68,337.

121. *Id.*

the 2006 changes to the executive compensation disclosure rules,¹²² when the SEC gives examples of issues that could be important, the company's proxy statement should address those issues, or the company likely will receive a comment letter from the SEC Staff.

Similarly, the Final Rule includes examples of issues that would potentially be appropriate for a company to address, including:

- The general design philosophy of the company's compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices relate to or affect risk taking by those employees on behalf of the company, and the manner of their implementation;
- The company's risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;
- How the company's compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short-term and the long-term, such as through policies requiring clawbacks or imposing holding periods;
- The company's policies regarding adjustments to its compensation policies and practices to address changes in its risk profile;
- Material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and
- The extent to which the company monitors its compensation policies and practices to

122. SEC Release No. 33-8732A, 71 Fed. Reg. 53518 (Aug. 29, 2006).

determine whether its risk management objectives are being met with respect to incentivizing its employees.¹²³

The Final Rule also requires companies to describe the board's role in the oversight of risk in the corporate governance disclosure section of the proxy statement, beginning in 2010.¹²⁴ The SEC believes that risk oversight is a key competence of the board, and that additional disclosures will improve investor and shareholder understanding of the role of the board in the company's risk management practices.¹²⁵ Disclosure about the board's involvement in the oversight of the risk management process, including credit risk, liquidity risk, and operational risk, will "provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company."¹²⁶

The Final Rule gives companies the flexibility to describe how the board administers its risk oversight function, whether through the whole board, a separate risk committee, or an audit committee.¹²⁷ "Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals."¹²⁸ The Final Rule adopts the phrase "risk oversight" instead of "risk management" to describe the board's responsibilities in this area.¹²⁹ The Final Rule also adopts the phrase "board leadership structure" instead of "company leadership structure" to clarify that the Final Rule does not require a discussion of a company's management leadership structure.¹³⁰

123. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,337.

124. *Id.* at 68,365.

125. *Id.* at 68,345.

126. *Id.*

127. *Id.*

128. *Id.* at 68,337.

129. *See* Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,337.

130. *Id.*

Finally, the Final Rule requires registered investment funds to provide disclosure about the board's role in risk oversight.¹³¹ Funds face a number of risks, including investment risk, compliance, and valuation, the SEC believes these additional disclosures will provide investors with a better understanding of the board's role in a fund's risk management practices.¹³²

B. Disclosure Regarding Compensation Consultants

Additionally, the Final Rule amends Item 407 of Regulation S-K to require disclosure about the fees paid to compensation consultants (and their affiliates) when the consultants were involved in determining or recommending the compensation arrangements of any executive or director, and provided other services to the company.¹³³ The Final Rule also requires a description of the role of the compensation consultant in determining or recommending the amount or form of executive or director compensation under the current disclosure rules.¹³⁴

If the board or compensation committee has an internal consultant the Final Rule requires fee and related disclosure if the consultant (or any affiliate) provides other non-executive compensation consulting services to the company, the fees for which exceed \$120,000 for a fiscal year.¹³⁵ It must further be disclosed whether the decision to engage the compensation consultant (or its affiliates) for non-executive compensation consulting services was made or recommended by management, and whether those services were approved by the board.¹³⁶

In situations where the board has not engaged an internal consultant, the Final Rule requires fee disclosures if there is a consultant (including affiliates) providing executive compensation consulting services and non-executive compensation consulting services to the company, only if the fees for non-executive

131. *Id.* at 68,345.

132. *Id.*

133. *Id.* at 68,345.

134. *Id.* at 68,347.

135. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,347.

136. *Id.*

compensation consulting services exceed \$120,000 for the company's fiscal year.¹³⁷

If the board has its own consultant, the company need not provide fee and related disclosure for consultants that work with management (whether for only executive compensation consulting services or for both executive compensation consulting and other non-executive compensation consulting services).¹³⁸

The Final Rule does not treat "services involving only broad-based non-discriminatory plans or the provision of information, such as surveys, that are not customized for the company, or are customized based on parameters that are not developed by the consultant," as executive compensation consulting services.¹³⁹

The SEC apparently believes that the new disclosure requirements will provide investors with information that will enable them to better assess the potential conflicts a compensation consultant may have in recommending executive compensation, and the compensation decisions made by the board.¹⁴⁰

C. Reporting of Stock and Option Awards in the Summary Compensation and Other Tables

The Final Rule requires companies to report stock and option awards in the Summary Compensation Table (SCT), and the Director Compensation Table (DCT) using the full aggregate grant date fair value of the award, as calculated under FASB ASC Topic 718, instead of the current requirement to report only the annual accounting charge.¹⁴¹

The Final Rule also significantly changes the reporting of performance-based awards by requiring that they be reported based on the probable outcome of the performance condition, rather than the amount payable for maximum performance.¹⁴²

137. *Id.* at 68,345.

138. *Id.* at 68,347.

139. *Id.* at 68,345.

140. *Id.* at 68,346.

141. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,360.

142. *Id.* at 68,362.

This will square the proxy reporting treatment with the accounting treatment. The SEC acknowledged that requiring companies to disclose an award's value based on maximum performance could overstate the intended level of compensation and result in investor misinterpretation of compensation decisions, which also could discourage the grant of awards with difficult – or any – performance conditions.¹⁴³ However, under the Final Rule, the company must report the potential maximum award value information in a footnote to the SCT or DCT.¹⁴⁴

D. Other Issues

1. Enhanced Director and Nominee Disclosure

The Final Rule requires companies to disclose for each director and any nominee for director the experiences, qualifications, attributes, or skills that led the board to conclude that the person should serve as a director for the company as of the time that a filing containing this disclosure is made with the SEC.¹⁴⁵ The Final Rule requires that companies make this disclosure annually because the composition of the entire board is important information for voting decisions. This new disclosure will be required for all directors, including those not up for reelection in a particular year.¹⁴⁶

The Final Rule does not require companies to disclose the specific experience, qualifications, or skills that qualify a person to serve as a committee member.¹⁴⁷ Notably, the SEC deleted the reference to “risk assessment skills” that was included in the proposed rules.¹⁴⁸ However, the Final Rule provides that if the Board chose an individual to be a director because of a particular qualification, attribute, or experience related to service on a

143. *Id.* at 68,339.

144. *Id.* at 68,362.

145. *Id.* at 68,341.

146. *Id.* at 68,342.

147. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,343.

148. *Id.* at 68,343.

specific committee then that should be disclosed as part of the individual's qualifications to serve on the board.¹⁴⁹

The Final Rule also “requires disclosure of any directorships at public companies and registered investment companies held by each director and nominee at any time during the past five years.”¹⁵⁰ The SEC believes that expanding this disclosure will allow investors to evaluate whether a director's or nominee's past board experience, as well as professional or financial relationships present a potential conflict of interest.¹⁵¹

2. Disclosures About Board Leadership Structure

The Final Rule requires changes to companies' 2010 proxy statement corporate governance disclosures. The Final Rule imposes “new disclosure requirements under Item 407 of Regulation S-K and makes a corresponding amendment to Item 7 of Schedule 14A to require disclosure of:” (i) the company's leadership structure, and (ii) why the company believes it is the most appropriate structure for it.¹⁵² A company is required to disclose whether and why it chose to either combine or separate the positions of chief executive officer (CEO) and board chair, and why it believes that this board leadership structure is the most appropriate structure for the company.¹⁵³ The SEC states that these provisions “are intended to provide investors with more transparency about the company's corporate governance, but are not intended to influence a company's decision regarding its board leadership structure.”¹⁵⁴ However, they appear intended to incentivize companies to implement a separation of the CEO and board chair positions.

149. *Id.*

150. *Id.*

151. *Id.* at 68,345 (The Final Rule also lengthens the time during which disclosure of legal proceedings involving directors, director nominees and executive officers is required from five to ten years, “as a means of providing investors with more extensive information regarding an individual's competence and character,” and expands the list of legal proceedings for which it requires disclosure.).

152. *Id.* at 68,344.

153. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,344.

154. *Id.* at 68,345.

3. Reporting of Voting Results on Form 8-K

The Final Rule makes one important change to reporting requirements for Form 8-K. The Final Rule transfers the requirement to disclose shareholder vote results from Forms 10-Q and 10-K to Form 8-K.¹⁵⁵ New Item 5.07 to Form 8-K requires companies to disclose the results of a shareholder vote and to have that information filed within four business days after the vote was held compared to what could be a few month before voting results are disclosed in a Form 10-Q or 10-K.¹⁵⁶ The SEC acknowledged that there might be situations, such as contested elections, where the company may need a longer period to determine definitive voting results.¹⁵⁷ Therefore, the SEC expanded the instructions to Form 8-K to require companies to file the preliminary voting results within four business days after the shareholders' meeting, and to then file an amended report on Form 8-K within four business days after the final voting results are known.¹⁵⁸ However, the Final Rule provides that if a company obtains definitive voting results before the preliminary voting results must be reported, it does not have to report its preliminary voting results on the Form 8-K.¹⁵⁹ The SEC also noted that the revisions to Form 8-K do not preclude a company from announcing preliminary voting results during the shareholder meeting at which the vote was taken and before filing the Form 8-K.¹⁶⁰

4. Foreign Private Issuers

The Final Rule does not contain an explicit exception from disclosure for foreign private issuers, but the Final Rule only applies to the extent the underlying rules of 402 apply. The introduction to Item 402 provides an exception for private issuers:

155. *Id.* at 68,350.

156. *Id.*

157. *Id.*

158. *Id.*

159. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,350.

160. *Id.*

(a) General. (1) Treatment of foreign private issuers. A foreign private issuer will be deemed to comply with this Item if it provides the information required by Items 6.B and 6.E.2 of Form 20-F, with more detailed information provided if otherwise made publicly available or required to be disclosed by the issuer's home jurisdiction or a market in which its securities are listed or traded.¹⁶¹

V. OTHER PROPOSED LEGISLATION ON EXECUTIVE COMPENSATION

Democrats in Congress introduced nearly a dozen bills¹⁶² on executive compensation issues in 2009, and the House even passed one.¹⁶³ Most of the provisions and restrictions of these proposed bills are similar to those imposed by TARP. Some of the proposed bills would apply only to financial institutions, while others would apply to all public companies.

No one can be certain of whether the full Congress will pass, or the President will sign, any of these bills into law, or what the final wording of the bills will be. However, nearly all of the bills have a few common provisions that could become law in 2010 or 2011. These common provisions are discussed below.

161. Regulation S-K, 17 C.F.R. § 229.402 (2008).

162. See Ending Excessive Corporate Deductions for Stock Options Act, S. 1491, 111th Cong. (introduced by Levin (D-MI), on July 22, 2009 and referred to the Senate Finance Committee); Corporate Governance Reform Act of 2009, H.R. 3272, 111th Cong. (introduced by Ellison (D-MN), on July 21, 2009 and referred to the House Committee on Financial Services); Shareholder Empowerment Act of 2009, H.R. 2861, 111th Cong. (introduced by Peters (D-MI), on June 12, 2009); Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (introduced by Schumer (D-NY), on May 19, 2009 and referred to the Senate Banking, Housing and Urban Affairs Committee); Excessive Pay Shareholder Approval Act, S. 1006, 111th Cong. (introduced by Durbin (D-IL) on May 7, 2009 and referred to the Senate Banking, Housing and Urban Affairs Committee); Excessive Pay Capped Deduction Act, S. 1007, 111th Cong. (introduced by Durbin (D-IL) on May 7, 2009 and referred to the Senate Banking, Housing and Urban Affairs Committee); Pay for Performance Act of 2009, H.R. 1664, 111th Cong. (introduced by Grayson (D-FL) and approved by the House on April 1, 2009); Compensation Fairness Act of 2009, S. 651, 111th Cong. (introduced by Baucus (D-MT) on March 19, 2009); Restoring American Financial Stability Act of 2009, 111th Cong. (introduced by Dodd (D-CT)).

163. The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 2004 (2009).

A. *Say on Pay*

Similar to TARP, nearly all of the proposed bills would require that any proxy or consent or authorization for an annual meeting of the shareholders to elect directors, occurring on or after a specified effective date, provide for a separate shareholder vote to approve the compensation of named executive officers (NEOs), as disclosed pursuant to SEC requirements. This vote would not be binding on the company. However, shareholder activists would almost certainly vote against the directors of any company that did not make changes in response to a negative say on pay vote.

B. *Disclosure and Shareholder Approval of Golden Parachute Compensation*

Most of the proposed bills also would require that any proxy for an annual meeting of shareholders provide for a separate shareholder vote to approve any “golden parachute agreements” maintained by the company. Again, this vote would not be binding on the company. However, shareholder activists would almost certainly vote against the directors of any company that did not make changes in response to a negative vote.

C. *Separation of CEO and Chairman Roles*

Most of the proposed bills would require that affected companies (generally, all publicly traded companies) split the roles of Chairman of the Board and Chief Executive Officer between two individuals.

D. *Clawback Provisions*

Most bills would require companies to develop and implement a clawback provision that would (i) be triggered by a financial restatement, (ii) cover all executive officers, and (iii) require recovery of all incentive-based compensation (including stock options) from the executive officers (both current and

former) for a period preceding the restatement in excess of what they would have been paid under the restatement.

E. Shareholder Reporting

Several of the bills would require every institutional investment manager to report at least annually how they voted on any say on pay or golden parachute vote given to shareholders.

F. Independent Compensation Committee

Nearly all of the proposed bills would require that public companies' board Compensation Committees to meet certain heightened independence standards, although, as a practical matter, most public companies' Compensation Committees already meet these standards.

G. Independent Compensation Consultant

Nearly all of the proposed bills also would allow the board Compensation Committees of public companies to have the ability to retain their own compensation consultant, independent from any consultant used by management or the company generally. Most bills also would require the public companies to disclose whether they have retained an independent compensation consultant.

H. Risk Assessments

Most of the proposed bills would require that public companies prohibit compensation policies and plans that encourage inappropriate risks that could: (1) threaten the safety and soundness of the company; or (2) have serious adverse effects on the company's financial stability. Most bills also would require a public company to assess its compensation plans for risk and disclose the results of that assessment.

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I. Disclosure Regarding Employee Hedging

Like TARP, most bills would prohibit – or at least require explicit disclosure of – whether a company permits its employees to purchase financial instruments that are designed to hedge or offset market declines affecting company stock awards.

VI. FOCUS ON EXECUTIVE COMPENSATION RISK ASSESSMENT FOR 2010

TARP requires covered financial institutions to implement compensation arrangements that exclude incentives for executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the institution during the period that the Treasury holds an equity or debt position in the financial institution. Now the SEC's Final Rule imposes a similar requirement affecting every public company, including financial institutions

A. The SEC's Final Rule

The SEC's Final Rule requires an institution to address its compensation policies and practices for all employees, including non-executive officers, to determine if the compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the institution, beginning with proxy statements filed on or after February 28, 2010.¹⁶⁴ Therefore, nearly every publicly traded financial institution in America must assess, in early 2010, whether its executive and employee compensation plans and agreements create risk. The Final Rule also allows companies to consider compensating or offsetting steps or controls designed to limit risks of certain compensation arrangements when addressing compensation policies and practices.¹⁶⁵ Part III discussed the Final Rule in detail.¹⁶⁶

164. Proxy Disclosure Enhancements, 74 Fed. Reg. at 68334 (for companies with fiscal years ending after December 20, 2009).

165. *Id.* at 68,336.

166. *See supra* Part III.

B. Companies Must Adopt a Process for Assessing Risk

Because every institution of every size has a different risk profile, there can be no “one size fits all” program for conducting the required risk assessment. However, many of the procedural steps to conduct a thorough and compliant risk assessment will be the same for most institutions.

Additionally, risk assessments inevitably will fail to catch or fully disclose some risks that lead to a loss – which in turn leads to a groundless lawsuit brought against the company that will cost it time and money to defend or settle. As in the case of internal investigations, the institution should consider that plaintiffs’ lawyers could use its risk assessment materials as a roadmap for litigation against the institution. Therefore, it is critical for an institution to carefully design and follow procedures that will demonstrate its best efforts to uncover and mitigate unnecessary risk.¹⁶⁷

1. Develop an Action Plan

An institution should develop a thorough process or action plan for assessing risk in its compensation programs. This action plan would create a structure (or starting point) for the assessment and set forth many of the steps that would be required of any institution, its board of directors, or the board’s Compensation Committee for the risk assessment process. The institution’s counsel and its compensation consultants should provide a list of factors that can help identify executive and employee compensation practices that create incentives for excessive risk taking, and discuss ways to manage or mitigate these risk factors.

2. Organization

Before diving into the risk assessment process, the board or Compensation Committee should sort through several organizational matters. One of the first matters is selecting the

167. It also is critical for institutions to understand the discoverability of documents created and the communications made during an assessment.

parties who should be involved in the process. At a minimum, the team must include the institution's senior risk officer (SRO) or an employee acting in a similar capacity, and the board's Compensation Committee. Other involved parties could include:

- The Audit Committee of the board;
- Other individual board members;
- Other institution personnel involved in risk management;
- C-suite executives;
- The institution's general counsel or other chief legal officer;
- Expert outside legal counsel; and/or
- An experienced compensation consultant.

From time-to-time during the process, the SRO, legal counsel, and other team members should consider whether the team should add any other members of management or the board or outside advisors.

A project leader should take particular care to ensure that there is at least coordination, if not consistency, regarding risk management and no duplication of effort as between the Compensation Committee, the Risk Committee, the Audit Committee, and/or other appropriate committees. As a preliminary matter, the institution should consider how much of the risk assessment process the Audit Committee of the board is already handling (or should handle). Audit Committees generally are familiar with risk. However, Audit Committees often are not familiar with compensation practices and metrics, or the institution's business strategy, as reinforced by its incentive plans. Additionally, the Audit Committee already may have as many duties and responsibilities as it can handle.

The Committee or project leader also should review existing risk management policies (including corporate governance guidelines and committee charters). Institutions already make a general risk disclosure in Form 10-K. NYSE Listed Company Manual Section 303A.07(c)(iii)(D) also requires a risk discussion.

3. Who Should Manage the Process?

If the institution has a disclosure committee (which most do), that committee likely has established a process to determine what is material to the institution and what is not. That standard could be useful to incorporate here. For example, such a process might provide that any transaction, action, matter or issue that would impact net revenues by one percent or more than \$X, must come to this committee for potential materiality review. Most financial institutions have a risk committee or group that could provide input on what are material institution-level risks—including reputational risks. It might be prudent for the institution to define first what its business goals are, then determine how the compensation arrangements can be best suited to achieve those goals, and what strategies would not be appropriate as they could cause behavior that threatens the value of the institution.

Each financial institution faces different material risks given the unique nature of its business and the markets in which it operates. Therefore, the Compensation Committee should discuss with the institution's SROs the risks (including long-term as well as short-term) that the institution faces that could threaten the value of the institution.

Ideally at this meeting the institution's SROs might describe the five to ten areas of risk that, in their opinion, could threaten the value of the financial institution. The parties then would discuss whether each element of the institution's compensation program could create incentives that encourage excessive risks in those areas. The committee should keep detailed meeting minutes of these discussions. One of the obvious items for a compensation committee to review carefully is asymmetrical incentive structures that have a highly leveraged upside payoff with limited or no downside. When an SEO (or other employee) is insulated from risk, he or she may behave differently than if the SEO were fully exposed to that risk.

4. What Makes a Compensation Program Risky?

The following are a few simplified examples of compensation program features that, under the Final Rule, could provide too much incentive for executives to take risk or otherwise manipulate financial results:

- The institution's annual (or long-term) bonus plan provides for a payout equal to 100% of base salary if the institution achieves a specified earnings per share (EPS) target – and no payout if the institution fails to achieve that target.
Risk implications: Executives are already under enormous pressure to achieve announced or expected EPS figures. This all-or-nothing approach would only exacerbate the problem. Instead, the institution should consider bonus payouts at 90% of base salary for achieving EPS that is barely below the target and straight-line interpolation downward for other, lesser performance targets.
- The institution provides equity incentive compensation solely in the form of stock options. Many of the stock options are underwater (i.e., the exercise or strike price is above the stock's current market price).
Risk implications: Executives need to “hit a grand slam home run” in terms of performance in order to see any return on their stock options. Slow, but steady, growth may not be enough. Ideally, the institution would provide part of its equity compensation in restricted stock or restricted stock units (RSUs), so that executives will receive some benefit for navigating through difficult financial times.

- The institution maintains an employee compensation program that provides cash incentive pay based on the number of transactions the employee makes, without a qualitative requirement (*e.g.*, did the transactions create profit for the institution and, if so, at what risk?).

Risk implications: If an employee is paid for the number of mortgages he or she originates, the employee may not exercise sound underwriting standards in determining whether to make a particular mortgage loan. The compensation should be tied to how the mortgage loan performs over time so that the employee's incentive is to make a sound loan, rather than just to generate a large volume of loans.

5. Make a List

The committee or project leader must create a list of all executive and employee plans maintained by the institution, which the team must review within the timeline of the process. The new risk review requirement, relates to all employee plans, thus greatly expanding the number and types of plans for which the committee is responsible, compared to current SEC requirements, which only apply to plans covering the top five NEOs. Some institutions have dozens of incentive and variable pay plans applicable to their sales force alone. A lower level committee or a subcommittee could review most of the plans that do not apply to NEOs, so the committee can continue to focus on the five to ten plans that are material to the institution.

6. Do it Right the First Time – But Plan for the Future

The committee or project leader should establish a timeline (including compliance dates) for the risk assessment process and, with the assistance of counsel, organize a series of meetings among

the parties. In some cases, outside counsel should conduct the meetings from an outline to ensure that the parties involved:

- Follow each of the steps;
- Ask all of the right questions;
- Get all of the right answers;
- Consider all necessary materials and information;
- Use their outside experts;
- Deliberate, if necessary;
- Reach all of the necessary conclusions;
- Document all of the foregoing through meeting minutes; and
- Follow through with the appropriate SEC reporting and disclosure.

During the process, the committee or project leader also should develop a framework and fine-tune the process for conducting the executive and employee compensation risk assessment, with input and guidance from all involved parties. The committee or project leader will need to develop written policies relating to risk management for the future.

7. SRO Risk Assessment and Report

The substantive part of the risk review process is understanding and differentiating between those forms of compensation that encourage appropriate risk and those that encourage excessive risk. Shareholders want management to take some risks with the institution's capital in order to achieve higher returns. However, ownership generally does not want management to take too much risk, unmanaged risk, unreasonable risk, or unknown risk. The challenge is to achieve the appropriate balance of risk and reward in executive compensation programs. Each institution faces different material risks given the unique nature of its business and the markets in which it operates.

The SRO, on behalf of the committee, and with input and guidance from other involved parties, should conduct a risk

assessment of the institution's executive and employee compensation plans and programs to identify the features of the plans and programs (or their administration) that could induce the executives or employees to take risks. The SRO and the committee also must determine whether each identified risk is material. In preparation for doing so, the SRO (and his or her team) should be briefed by human resources executives and the committee's compensation consultant on the philosophy and design of the executive and employee compensation programs and the performance metrics, payout curves, and other factors that drive incentive payouts.

The SRO also should become familiar with (i) how the CEO and the committee evaluate individual executive's and employee's performance for purposes of allocating rewards and promotions, (ii) the factors and process the committee and board use in evaluating the CEO's performance, and (iii) the complexities and potential consequences of certain events and decisions on each compensation program.

The SRO, with input and guidance from all involved parties, should identify the short- and long-term risks the institution faces according to the following general categories:

- Employee compensation plans or features that encourage the manipulation of reported earnings of the institution to enhance the compensation of an employee.
- Risks that endanger the institution's existence as an ongoing enterprise.
- Risks that pose material harm to the institution's value including a review of factors identified in the Final Rule.
- Reputational risks, which include exposure to criticism or an adverse public image with shareholders and customers, difficulty with proxy voting on proposals regarding executive compensation or share availability, and board embarrassment – particularly regarding severance arrangements.

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- Financial risk.
- Operational risk.
- Liquidity risk.
- Litigation risk.
- Regulatory risk.
- Customer risk.

8. Compensation Committee Assessment, Response, and Implementation

Once the SRO has completed its assessment and report, it should meet with the committee and other involved parties to review the assessment and report. The SRO, team leader and other involved parties should have separated out the plans, programs, or features that do not pose a material financial, reputational, or other risk to the institution, or otherwise encourage the manipulation of reported earnings to enhance employee compensation.

Most compensation plans contain incentives that create some risk. However, because the risk assessment process requires a review of all employee plans and programs, many of these plans will:

- Be at an employee level where the amount of risk is very low, or
- Involve risks that are not material or are clearly well managed or mitigated.

The Compensation Committee should discuss the SRO's report and evaluate or deliberate over the alternative methods of reducing, managing, or mitigating: (a) the incentive to take excessive risk, and (b) any plan features that could encourage the manipulation of reported earnings to enhance the employee's compensation.

The committee then should decide upon the design or administrative changes needed, if any, to the compensation plans in order to reduce, manage, or mitigate: (a) the incentive to take those risks that threaten to harm the institution, and (b) plan

features that could encourage the manipulation of reported earnings to enhance the employee's compensation. Recommendations for these changes could come from the SRO, the compensation consultant (or other independent advisor), human resources executives, legal counsel, or other expert sources.

The committee should inform the full board, the CEO, the SRO, the Chief Legal Officer, and other involved parties of the findings of its risk assessment, its tentative decisions, and the program changes, if any, it is considering. The committee should consider management and legal input. The committee (or its chair) should brief the full board and consider board input. In particular, the committee should discuss with the board, the CEO, the SRO, Chief Legal Counsel, and other involved parties, any necessary or recommended changes to the corporate governance structure or committee charters regarding risk management. The institution will need to disclose any changes it makes in the proxy statement description of the board's role in the institution's risk management, discussed further below.

Once the committee has made its final decisions based on the results of the assessment and input of all involved parties, it should instruct management and others as to any changes they must make.

9. Repeating the Process

The institution will need to repeat some version of the executive and employee compensation risk assessment process annually. The committee should evaluate the results of the compensation risk assessment and adopt changes to improve its future effectiveness. The institution may find it appropriate to fold the compensation risk assessment into an overall human resources risk assessment conducted for the committee by the institution's human resources and risk management staff in cooperation with the committee's advisors. The institution should charge its internal auditors with the responsibility of ensuring that the institution actually follows the risk management processes and standards it has adopted.

10. Other Matters

During the assessment process or at its conclusion, the institution or the committee should develop written policies and guiding principles for proposing, establishing, and monitoring compensation and incentive plans that can be applied institution-wide in the future, which will make future risk assessments easier.

Although not required by law, the risk assessment team could consider other areas of risk as part of its review. For example, the team could review and seek to minimize the risk of calculation errors. The committee could consider retaining the institution's independent auditor or compensation consultant to review management's calculation of performance measures and the amount of the annual incentive awards to be paid to executive officers, in order to report to the committee whether such calculations were accurate and properly prepared.

Certain other "risks" may not threaten the value of the institution, but could easily be reviewed within the risk assessment process, including the risk of drafting errors, the risk of paying too much or too little compensation, and the risk that the institution has misaligned its compensation programs with its strategy.

VII. CONCLUSION

The limitations on executive compensation first initiated by the EESA and directed specifically towards financial institutions receiving TARP funds has changed the world of executive compensation for all publicly traded corporations. For one, no longer are the limitations and restrictions limited solely to financial institutions. Secondly, besides the limitations imposed under the EESA, the Fed's Guidance and the SEC's Final Rule require a company to go beyond evaluating the compensation policies and practices of executives and include any employee whose compensation is reasonably likely to have a material adverse effect on the company. All of the programs and legislation are designed to address one overall concern, which is to prevent institutions from developing executive compensation packages that create excessive risk.

The EESA provides specific limitations such as a prohibition on compensation plans that encourage earnings manipulation, the awarding of bonuses, retention awards, or other incentives, a limitation on luxury expenditures, and calls for the implementation of a clawback provision and say on pay and more. The Fed's proposed guidance on incentive compensation arrangements is an outgrowth of the executive compensation limitations of the EESA, but as the proposal states it is only relevant to incentivized compensation. The FDIC is yet another regulatory agency which is seeking ways to modify the risk-based deposit insurance assessment system to account for the risk posed by employee compensation arrangements. The SEC's Final Rule clarifies the disclosure requirements of compensation policies and practices, compensation consultants, stock and option awards, and other matters regarding directors and officers, and applies to all publicly traded corporations. Many of the proposed legislative bills before Congress today seek to implement a combination of the provisions addressed in the EESA and Final Rule. They include say on pay, the disclosure of golden parachutes, and clawback provisions, but they also include additional requirements such as a separation of CEO and Chairman roles, shareholder reporting, and disclosure regarding employee hedging.

The key to the successful prevention of excessive risk will be for companies to assess properly the risks posed by executive compensation. Every institution will need to develop a risk assessment process unique to its structure, objectives, and risk profile. Important considerations when developing a process include deciding who should be involved in the process, who should lead the process, what compensation features incentivize excessive risk, which risks are material, and how the results of the assessment will be implemented. Without a risk assessment process in place that can monitor a company's compliance with the EESA, Final Rule, and whatever other executive compensation legislation that may be passed, companies will have a hard time meeting executive compensation requirements.