Transatlantic Corporate Governance Dialogue

"The New Role of Government in Corporate Governance"

An Illustration:

U.S. Legislative and Regulatory Developments
Affecting Executive Compensation

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RECENT GOVERNMENT DEVELOPMENTS AFFECTING EXECUTIVE COMPENSATION

1. Pre-TARP Company-specific Interventions

2. TARP Related

a. Emergency Economic Stabilization Act of 2008 (EESA)

b. American Recovery and Reinvestment Act of 2009 (ARRA)

- New Regulations pursuant to ARRA adopted by U.S. Treasury June 15, 2009

c. New Pay Restrictions and Standards for Covered Financial Institutions; New Pay Czar ("Special Master") appointed: Kenneth Feinberg

3. Say-on-Pay Developments

- Important legislative support for this shareholder advocate development

4. Other Notable Developments

a. Proposed legislation including Corporate and Financial Institution Compensation Fairness Act of 2009 (Bill passed House July 31, 2009; referred to Senate)

b. Attention at the State level: Cuomo Report on Executive Pay at Certain Banks

A SELECTED LIST OF HISTORICAL U.S. GOVERNMENT INTERVENTIONS IN EXECUTIVE PAY SINCE 1970

Direct Intervention	SEC Disclosure and Other Requirements	Statutory and Regulatory Tax Rules	Other
Early 1970s – Pay and Price Controls	1992 – Major Changes in Proxy Statement Disclosure Requirements	1984 – Golden Parachute Tax 20% Excise Tax on Certain Payments and Entitlements in Connection with Changes in Control (Code Sections 280G and 4999)	2002 – Sarbanes Oxley Act Prohibits personal loans to certain senior executive officers and directors; provides for clawback of incentive compensation from the CEO and CFO if financial reports are misstated "as a result of misconduct"
	2004 – Accounting Change (FASB initiated): Expensing of Stock Options (FAS 123R)	1993 – $1 Million Cap on Deductibility of Non-Performance Based Executive Pay (Code Section 162(m))	Periodic Government Investigations
	2006 – Another Major Change in Proxy Statement Disclosure	2004 – Additional 20 Percent Tax on Certain Deferred Compensation (Code Section 409A)	

INTERVENTIONS IN THE CURRENT FINANCIAL CRISIS

Two Pre-TARP Events That Produced Executive Pay "Fall-outs"*

1. AIG (September 2008)

On September 16, 2008, the U.S. Federal Reserve announced that it would loan through a credit facility up to $85 billion in order to prevent a feared systemic failure in the financial community triggered by a collapse of AIG, and in exchange received a 79.9 percent interest in AIG. (AIG subsequently received additional government assistance, including approximately $70 billion in TARP funds through the sale of preferred stock with warrants to the Treasury.)

***Fall-out**: Bonuses paid to many executives after bail-out raised wide outcry and Congressional proposals for a special tax on these bonuses.*

* Two company-specific Government interventions involved the Bear Stearns collapse (Bear Stearns merged into JP Morgan pursuant to agreement entered into in March 2008) and Lehman Brothers (filed for bankruptcy September 15, 2008). Neither of these events, both of which involved intervention by the U.S. Treasury and Federal Reserve, resulted in executive pay controversy (there being nothing to "pay out").

Interventions in the Current Financial Crisis
Two Pre-TARP Events…

2. Bank of America / Merrill Lynch (September – December 2008)

Under substantial pressure from Washington, Bank of America agreed on September 15, 2008 to acquire Merrill Lynch. The acquisition closed January 1, 2009. In addition to playing a central role in the acquisition, the U.S. Government guaranteed Bank of America as to certain potential losses in connection with the transaction. The Treasury invested in Bank of America $25 billion in October 2008 and another $20 billion in January 2009.

Fall-out*: Bonuses paid out to Merrill Lynch executives after bail-out (and without adequate disclosure to Bank of America shareholders, according to lawsuits) raised further outcry. Congressional hearings and litigation followed.*

Chapter One: Emergency Economic Stabilization Act of 2008 (EESA) (Enacted October 3, 2008)*

Restrictions on Executive Compensation for Senior Executive Officers of Companies That Participate in TARP

EESA authorized the U.S. Treasury Department to "acquire" $700 billion of "troubled assets." Unlike its stated purpose (purchase of "troubled assets" from troubled banks and other financial institutions), this became a program in which, among other things, the Treasury purchased preferred stock and subordinated debentures, and received warrants for future purchases of common stock, additional preferred stock or subordinated debentures. Originally focused on nine systemically critical banks, TARP ultimately provided assistance to over 670 companies.** In fact, EESA did not impose very stringent limitations on executive pay. In certain cases, severance payments were limited to three times average compensation over a number of years; in other cases (in which the Treasury acquired more than $300 million in troubled assets from an institution), deductions for tax purposes have been prohibited to the extent the amount of "executive remuneration" paid exceeds $500,000. ARRA is much stricter (next slide).

* On February 4, 2009, the U.S. Treasury proposed its own guidance on executive pay (TG-15). This guidance has been superseded by ARRA and regulations thereunder.

** Commencing on December 29, 2008, the Treasury made loans to and, in some cases, purchased stock from Chrysler and General Motors pursuant to the Automotive Industry Financing Program under TARP.

Chapter Two: American Recovery and Reinvestment Act of 2009 (ARRA) Signed into Law February 17, 2009 (amending EESA)

*Congress "Straight Jackets" Senior Executive Pay at TARP Recipients**

ARRA substantially tightened the executive pay restrictions on TARP Recipients by expanding the number of executives covered (different numbers applicable in respect of different compensation/situations), imposing stricter limitations on incentive payments and severance payments (among other restrictions), and adding new corporate governance standards and requirements. These restrictions and standards apply so long as the obligations arising from financial assistance under TARP remain outstanding (the "TARP Period").** Under ARRA, TARP Period ends even if the Government still holds warrants. A "Pay Czar" was appointed pursuant to this legislation – substantial authority to review pay of executives and other highly compensated employees at TARP Recipients.

* A TARP recipient is defined as "any entity that has received or will receive financial assistance" under TARP.

Other Developments….Proposed Legislation

Proposal Introduced by Rep. Charles Rangel: 90 Percent Tax on "TARP Bonus"

Following public outcry over bonus payments at AIG, on March 19, 2009, the House passed and sent to the Senate a bill (H.R. 1586) that would impose an income tax at the rate of 90 percent on certain bonuses (within the meaning of "TARP Bonus" as defined in the bill) paid to employees of TARP Recipients receiving "capital infusions" in excess of $5 billion (such excess to be reduced by repayments to the Federal Government) and certain other entities.

Other Developments….Proposed Legislation

CORPORATE AND FINANCIAL INSTITUTION COMPENSATION FAIRNESS ACT OF 2009*

(Passed House July 31, 2009; Referred to Senate)

Contains provisions covering:

a. Say on Pay
   - See additional comments on next two slides

b. Compensation Committee Independence

c. Incentives that encourage financial institutions to take undue risks**

* Numerous other bills related to executive compensation were introduced in Congress in 2009, some relating to TARP and others non-TARP related. Anyone interested in a compilation of the legislation should email a request to Joe Bachelder at jeb@jebachelder.com.

** Note also that on July 10, 2009 the SEC proposed certain rules regarding executive compensation disclosure in proxy statements of public companies, including a new rule requiring discussion of risk-related aspects of an issuer's compensation of its employees.

Other Developments….Say on Pay

SAY ON PAY DEVELOPMENTS

a. Non-TARP Legislative Developments. A number of bills have been introduced in Congress in recent years intended to require Say on Pay.* These include:

Name of Bill	Year Introduced	Introduced by:
Shareholder Vote on Executive Compensation Act (H.R. 1257)	2007	Representative Barney Frank (passed House of Representatives)
Shareholder Vote on Executive Compensation Act (S. 1181)	2007	Then-Senator Barack Obama
Corporate Executive Compensation Accountability and Transparency Act (S. 2866)	2008	Then-Senator Hillary Clinton
Shareholder Bill of Rights Act of 2009 (S. 1074)	2009	Senator Charles Schumer
Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269)	2009	Representative Barney Frank (passed House of Representatives 7/31/09; referred to Senate Banking Committee)

* For this purpose, "Say on Pay" means giving shareholders the right to express their approval or disapproval, on a nonbinding basis, of executive compensation practices at the company of which they are shareholders.

Other Developments….Say on Pay

b. Legislative and Regulatory Requirements under TARP

Under ARRA, TARP Recipients are required to provide a nonbinding shareholder vote on the compensation of the executives whose compensation is required to be disclosed under SEC disclosure rules. On July 1, 2009, the SEC published proposed rules 74 Fed. Reg. 32474 pursuant to ARRA's Say-on-Pay requirement. ARRA, Section 111(e); see also 74 Fed. Reg. 28,394.

c. Other Non-Legislative Developments

Say on Pay has been part of shareholder advocates' proposals for a number of years. In 2007 Aflac became the first company in the U.S. to adopt a Say-on-Pay policy, and at least 22 other companies have since adopted Say-on-Pay policies. In addition, TARP companies, starting in the 2009 proxy season, are required to hold say-on-pay votes. They will remain subject to this requirement throughout the period of their TARP obligations. Thus far, there have been no instances where a majority of shareholders of U.S. companies have voted against their company's executive compensation practices.

MISCELLANEOUS DEVELOPMENTS

a. Public Statements by Government Officials

President Barack Obama (September 14, 2009):

"[H]ear my words: We will not go back to the days of reckless behavior and unchecked excess at the heart of this crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses."

Federal Reserve Chairman Ben Bernanke (March 24, 2009):

"It's very important that compensation links performance and reward appropriately and, in particular, does so in a way that does not incentivize excessive risk-taking."

Treasury Secretary Timothy Geithner (March 24, 2009):

"The government should not be setting detailed or prescribing detailed regulations to govern amounts of compensation and their distribution."

Other Developments….Miscellany

b. U.S. Administration Statement of Principles on Executive Pay

On June 10, 2009 (in TG-163), the U.S. Administration issued a “statement of principles” regarding executive compensation. The statement includes executive pay principles covering the measuring and rewarding of performance, taking into account risks and sound risk management, use of golden parachutes and supplemental retirement packages and promoting transparency and accountability in the process of setting compensation.

c. Report on executive pay in the banking industry by New York State Attorney General Andrew Cuomo (issued July 30, 2009)

This report addresses executive pay at nine companies, all of which are recipients of TARP aid.

CONSEQUENCES OF GOVERNMENT INTERVENTION INTO EXECUTIVE COMPENSATION

<u>Have the Executive Compensation Restrictions "Worked"?</u>

1. **Are senior executives at TARP companies being paid less than if there had been no TARP? Will this continue once TARP restrictions lift? Will TARP restrictions be a very temporary "hiccup" in executive pay…and at a very limited number of companies?**

   a. Pay-back of TARP funds has already begun.

      - Goldman Sachs, JPMorgan, Morgan Stanley, American Express, State Street, Bank of New York Mellon, BB&T, Capital One, U.S. Bancorp and Northern Trust

   b. Goldman Sachs, for example, announced large reserves for bonuses to be paid in respect of 2009.

   c. Will TARP even "be around" one or two years from now?

Consequences of Government Intervention….

2. **Are we putting fragile TARP companies at current risk of losing talent to other financial institutions (including foreign companies) not subject to TARP constraints on compensation?**
    - Is this a case of the stronger getting stronger at the expense of the weaker? Is it good policy to encourage this?

3. **Is TARP having a perverse effect on executive pay practices? For example, have we gone overboard in encouraging salary and discouraging performance-based pay (e.g., short-term incentives)?**
    - John Stumpf at Wells Fargo
    - Robert Benmosche at AIG