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Federal Reserve Board and TARP Special Master Take Action on Compensation Practices

On October 22, 2009, in a coordinated effort, the Board of Governors of the Federal Reserve System (the "Board") and the Special Master for TARP Executive Compensation, Kenneth R. Feinberg (the "Special Master"), took actions with respect to employee compensation at certain financial institutions and TARP recipients.

First, the Board issued for public comment Proposed Guidance on Sound Incentive Compensation Policies (the "Proposed Guidance"), which includes two supervisory initiatives, applicable to all "banking organizations"[1] supervised by the Federal Reserve. Although the Board's Proposed Guidance is open for a thirty (30) day public comment period, the Board indicated that nonetheless it expects banking organizations to review *immediately* their incentive compensation arrangements, to ensure that they do not encourage excessive risk-taking and to implement corrective programs where needed.

Second, the Special Master issued his first Rulings on compensation packages for the five (5) most senior executives and the next twenty (20) most highly-compensated employees at each of the seven (7) firms that received "exceptional" TARP assistance (AIG, Bank of America, Chrysler, Chrysler Financial, Citigroup, General Motors and GMAC).

The Board's Proposed Guidance. The Board stated that the Proposed Guidance is intended to help protect the "safety and soundness" of banking organizations by ensuring that incentive compensation arrangements do not encourage excessive risk-taking. Additionally, the Board stated that supervisory action can play a critical role in addressing the "first mover" problem, which some believe might make it difficult for individual firms to act alone to address misaligned incentives. By requiring all banking organizations to be treated the same way, the Board believes it will eliminate the concern that employees might voluntarily leave a banking organization that has reformed its incentive compensation practices to go to one that has not.

The Board articulated the following three principles for incentive compensation. Incentive compensation should:

- provide employee incentives that do not encourage excessive risk-taking beyond the organization's ability to effectively identify and manage risk,
- be compatible with effective controls and risk management, and

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1 These "banking organizations" include US bank holding companies, state member banks, Edge and agreement corporations and the US operations of foreign banks with a branch agency or commercial lending subsidiary in the US.

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- be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.[2]

The Proposed Guidance intentionally did not include any specific rules, such as pay caps or prohibitions on specific forms of compensation, in recognition that "one size does not fit all." However, the Board did invite comment on whether specific rules would be appropriate.

Lastly, the Board announced the following two supervisory initiatives to induce banking organizations to adhere to the principles described in the Proposed Guidance:

- A special "horizontal review" of the incentive compensation practices at twenty-eight (28) unnamed large, complex banking organizations
- A review of incentive compensation practices at other banking organizations as part of the regular risk-focused examination process for these organizations.

The Board's staff will examine whether the incentive compensation arrangements and processes of banking organizations are consistent with the Proposed Guidance, and deficiencies will be factored into banks' ratings and, where appropriate, corrective action may be required.

The Proposed Guidance also included a detailed FAQ.

The TARP Special Master's Rulings. The TARP Special Master's Rulings address up to 175 employees in the aggregate (twenty-five (25) employees at each of the seven (7) firms that received exceptional assistance). Under the Rulings:

- large cash payments based on short term performance will generally not be made,
- guaranteed cash payments will be restructured as stock payments that must be held over a long term,
- cash base salary will generally be limited to $500,000, and the majority of non-cash salary will be paid in vested stock that can be sold only in 33-1/3% annual installments beginning in 2011 (unless TARP funds are repaid earlier),
- incentive compensation will be paid only if both (i) objective goals are met and (ii) TARP funds are repaid. Awards will require three years of service after the award and will not be payable until after TARP funds are repaid, and
- perquisites generally are capped at $25,000, accruals under SERPs are frozen and increases in the amount of any "golden parachutes" are prohibited.

We are monitoring these and related developments closely and will provide further updates as events unfold.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. If you have any questions regarding the foregoing, please contact:

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[2] Note these principles and guidance are consistent with the Principles for Sound Compensation Practices adopted by the Financial Stability Board in April 2009 and the implementation standards for those principles which were issued in September 2009.