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FREDERIC W. COOK & CO., INC.

Executive Compensation Strategy and Disclosure After the Credit Crisis

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Agenda

- Trends in Compensation Design
- Emergency Economic Stabilization Act
- Compensation Tax Issues
- Pending Legislation
- ISS: Proxy Advisor Recommendations on Shareholder Votes
- Shareholder Activist Initiatives
- Compensation Disclosure Considerations
- Questions and Answers

Trends in Compensation Design

- Companies are reevaluating salary increase budgets for 2009
  - Some slashing original budgets in half or freezing altogether
- Target bonuses continue to escalate at the top levels, but have stabilized at lower levels
- Actual bonuses for 2008 are expected to decline significantly due to deteriorating economic conditions
  - Some relief will be provided, but most will be below target
  - Expectation of “softer pitches” in goal setting process for 2009
- Long-term incentive (LTI) values for 2009 are expected to decline significantly due to collapse of stock valuations
  - Companies simply cannot grant enough shares to be competitive

Trends in Compensation Design

- Broad concern about retention has abated
  - "Where are people going to go?"
- But retaining high performers and critical skills remains a priority
  - Targeted as opposed to widespread retention equity and cash awards
- A lot of talk about underwater stock option exchanges, but little action to date
  - Unlikely to be as widespread as following tech bubble burst because of diversified LTI programs
- Perks, gross ups, special benefits, severance, and change-in-control benefits are being downsized as committees reevaluate past practices in new light

Trends in Compensation Design

- Clawback/recoupment policies rapidly becoming standard practice
  - Typical policy applies to Section 16 officers and seeks reimbursement of incentive compensation based on financial results that are materially restated due to misconduct and the payments would have been lower
  - Trend may be to emulate EESA provisions that do not explicitly require “restatement” or “misconduct” to trigger clawback
- Compensation committees outside of financial institutions may be compelled to develop framework for conducting executive compensation risk assessments
  - May lead to substantial shift away from performance-based compensation

EESA

Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008 (the "Act") established executive compensation limits on financial institutions that sell assets to Treasury under the Troubled Asset Relief Program ("TARP")

- Under the Act, limitations differ depending on whether assets are acquired by Treasury through
  - Direct purchase or
  - Auction purchase (where financial institution sold an aggregate of more than $300 million, including both auction sales and direct sales)
- Treasury Secretary Paulson indicated in a speech on November 12, 2008, that the auction purchase method is now not intended to be utilized

Treasury Issues Guidance on Executive Compensation and Corporate Governance Provisions Under the Act

- Interim Final Rule for the TARP Capital Purchase Program ("CPP") is in effect (31 CFR Part 30)
  - Treasury will consider comments on this CPP rule before issuing final rule
- IRS Notice 2008-94 provides guidance under new Internal Revenue Code Section 162(m)(5), which applies by contract to CPP institutions
- Other guidance issued for financial institutions participating in programs for systemically significant failing institutions and auction purchases

EESA

Executive Compensation and Corporate Governance Standards Under the CPP

- Avoid Risky Incentives: Compensation Committee must ensure that incentive compensation arrangements do not encourage senior executive officers ("SEOs") to take unnecessary and excessive risks that threaten financial institution's value
- Implement "Clawback" Mechanism: Financial institution must be able to recover any bonus or incentive compensation paid to a SEO based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria
- Prohibit Golden Parachutes: No golden parachute payments to any SEO
- Limit Compensation Deduction for SEO Pay Exceeding $500,000: Financial institution must agree to limit its compensation deduction to $500,000 per year for each SEO

Who Is Covered by the Executive Compensation Standards?

- Financial institutions participating in the CPP, and any other entity in its controlled group
- Standards are applicable only to SEOs of such institutions while Treasury holds an equity or debt position (the "CPP Period")
  - This applies to the top five "named executive officers" as defined in Item 402 of Regulation S-K for public companies (*i.e.*, the CEO, the CFO and the three most highly compensated executive officers)
  - Rules apply by analogy to private companies and companies that do not have shares registered with the SEC
- Use best efforts to identify three most highly compensated executive officers for the current fiscal year, until compensation data for this year are available

EESA

Avoid Risky Incentives

- Compensation Committee must meet with “senior risk officers”
  - Within 90 days of the CPP purchase
  - Thereafter, annually (at a minimum)
- Compensation Committee must certify that it has had such meetings and that it has taken reasonable efforts to ensure that SEO incentive compensation arrangements do not encourage SEOs to take “unnecessary and excessive risks”
  - Public companies: file as part of proxy disclosure
  - Private companies: file with primary regulatory agency
- Determination of senior risk officers
- Determination of material risks specific to the financial institution

Implement "Clawback" Mechanism

CPP clawbacks are broader than what is required by SOX

- CPP clawback provisions
  - All SEOs
  - All CPP participants
  - Financials or performance metrics with inaccuracies
  - Any bonus or incentive compensation paid based on such inaccuracies (during CPP Period)
- SOX clawback provisions
  - Only CEO & CFO
  - Only public companies
  - Only accounting restatements
  - Only bonus or incentive compensation paid during a 12-month period

Prohibit Golden Parachutes

- Under CPP, "golden parachutes" are not change in control payments
- "Golden parachute" means any compensation paid to a "covered executive" on account of an "applicable severance from employment" that is at least 3 times the SEO's "base amount"
  - Involuntary terminations (including "good reason" terminations) or terminations related to bankruptcy, insolvency or receivership
  - "Base amount" looks at 5-year average compensation under IRC 280G rules
- Rules do not impose limits on compensation received while employed
- Change in control payments are governed by preexisting IRC 280G rules

Limit Compensation Deduction for SEOs Exceeding $500,000

- The Act adds a new IRC Section 162(m)(5), which:
  - Limits the tax deduction of certain institutions participating in the TARP to $500,000 per year for each “covered executive”
  - Does not contain a performance-based exception for any compensation of “covered executives”
  - This deduction cap is not limited to public companies
- IRC 162(m)(5) does not apply under the CPP, but Treasury requires financial institutions to apply the deduction limit by agreement as a condition to CPP participation

EESA

SEO vs. Covered Executive

- The prohibition on "golden parachute" payments and the $500,000 limit on the financial institution's deduction applies to "covered executives"
- The "covered executives" are generally the same as the SEOs, with one modification:
  - Once an individual becomes a "covered executive" for an applicable taxable year, he or she remains a covered executive for the remainder of the CPP Period
  - Therefore, these limitations may apply to a broader group of individuals

Compensation Tax Issues

Code Section 409A

- Generally regulates the payment timing of deferred compensation by imposing adverse tax consequences on the individual if certain requirements are not met
  - 20% additional income tax
  - Acceleration of income inclusion
  - Potential interest and penalties
- Deferred compensation is defined very broadly and includes many different types of arrangements, including employment agreements, severance plans and change in control benefits
- By December 31st, all deferred compensation arrangements must be in written compliance with its requirements
- These rules could restrict the ability to restructure existing arrangements for CPP purposes, best practices or business reasons

Compensation Tax Issues

Code Section 162(m)

- Generally, limits compensation deduction to $1 million for certain executive officers of public companies
  - "Performance-based" compensation is exempt from limit
- Rev. Rul. 2008-13: no longer exempts performance-based compensation that can be paid on involuntary termination or retirement
  - Compensation paid before January 1, 2009 grandfathered
  - Compensation paid pursuant to an agreement in effect on February 21, 2008 grandfathered
- CAUTION:
  - Amending agreements could eliminate grandfathered status
  - Establishment of 2009 and future performance goals should comply with this ruling for the company to maintain its deduction

Pending Legislation

Corporate Executive Compensation Accountability and Transparency Act
S. 2866 (Sen. H. Clinton)
(In Senate Finance Committee)

- May be reintroduced under new administration
- Limits nonqualified deferred compensation deferrals to $1 million annually under IRC §409A
- Broadens SOX §304 CEO/CFO recoupment provisions
- Mandates say-on-pay nonbinding shareholder vote on executive compensation
- Prohibits conflicts of interest of executive compensation consultants
- Requires proxy disclosure of grant date fair value of equity awards rather than accounting accrual in Summary Compensation Table

RiskMetrics Group 2009 Poor Pay Practices Policy (Draft)

Proposed Amendments to RMG's Policy

- Criteria for determining compensation committee withhold vote recommendations would replace absolute negative 1- and 3-year total shareholder return (TSR) test with relative 1- and 3-year bottom quartile of GICS-code peer group test
- Additional poor pay practices
  - Modified Single Trigger
  - Dividends on Unvested Performance Shares
  - Excise Tax Gross-Ups
  - Excessive Perks

Shareholder Activist Initiatives

Overview

- Expect shareholder proposals to reflect current events (e.g., intensified focus on executive compensation, EESA restrictions)
- New legislation seems a more realistic means to accomplish goals than in the past (e.g., S. 2866 (Sen. H. Clinton))

Compensation Disclosure Considerations

Overview

- Political atmosphere: greater scrutiny by regulators and activist investors
- Regulatory initiatives: SEC's continued dissatisfaction with CD&A disclosure
- Influence of EESA provisions on "best practices"

Compensation Disclosure Considerations

Political Atmosphere

- EESA and the uproar over executive compensation focusing on financial services (e.g., AIG freezes $19 million in payments to former CEO)
- Consensus that regulatory framework needs to be “beefed up”
- Increased likelihood of legislation from Democratic Congress, Administration
- Will the SEC apply more scrutiny going forward under a new Chairman?

Regulatory Initiatives

- Possibility of more activist SEC with new Chairman
- Ongoing push by the Division of Corporation Finance to more "how and why" in CD&A disclosure (e.g., John White's speech last month – more to come)
- Part of regular review and targeted review for largest financial institutions

Compensation Disclosure Considerations

Speech by SEC's John White

October 21, 2008

In 2008, the SEC commented most on the following aspects of second-year compensation disclosure:

- Performance targets
- Benchmarking
- Analysis

Speech by SEC's John White

October 21, 2008

- Extension of TARP compensation principles to <u>all</u> companies?
- Compensation Committees of <u>all</u> companies should consider the particular risks an executive might be incentivized to take to meet performance targets
- <u>All</u> companies should carefully consider if and how recent financial events affect its compensation program
- Think about what Congress might want

Disclosure: Our checklist

- Change processes/procedures for setting executive and director pay
- Changes to outstanding awards or existing plans
- Waiver or adjustment of performance measures
- Avoid boilerplate: Take into account recent market events
- Provide more "how and why" disclosure, but particularly about hot areas, such as severance arrangements and compensation risk assessments

Q and A

Questions and Answers

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