HINSHAW
& CULBERTSON LLP

Regulatory Issues in Financial Institution Executive Compensation

Timothy M. Sullivan
Hinshaw & Culbertson LLP
222 North LaSalle Street
Suite 300
Chicago, Illinois 60601
312-704-3852
tsullivan@hinshawlaw.com
February 1, 2011

Index

General 1

Regulatory Guidance on Sound Incentive Compensation Policies 2
General 2
Regulatory Examinations; Enforcement 3
Definitions 4
Principles of a Sound Incentive Compensation System 5
Ongoing Supervisory Initiatives 15

Treasury Final Rule on Executive Compensation Limits for TARP Recipients 16
General 16
Scope of Rules 16
Persons Covered 17
Limitation on a TARP Recipient's Compensation Tax Deduction 17
Compensation Committee 17
Clawback 19
Severance Prohibited 20
Limits on Bonuses, Retention Awards and Incentive Compensation 21
Limits on Luxury Expenditures 25
Shareholder Non-Binding "Say on Pay" 26
Additional Requirements 26
Acquisitions 27
Compliance Certifications 28
Special Master 29
Effective Date 29

Compensation Provisions Applicable to Public and Private Financial Institutions 30

Compensation Provisions in Regulatory Orders 30
Management and Director Compensation 30
Golden Parachute Payments 31
Employment Contracts and Compensation Arrangements 31
Third Party Contracts 32

Incorporating Employee Compensation Criteria Into The Risk Assessment System 32
General 32

New Requirements Under Dodd-Franks Wall Street Reform and Consumer Protection Act 36
Say on Pay 36
Golden Parachutes 37
Clawbacks 37
Additional Executive Compensation Disclosures 38
Compensation Committee Independence 38
Compensation Committee Advisor Independence and Disclosure 39

Regulatory Issues in Financial Institution Executive Compensation

General

In the last couple of years, bank regulators have been taking steps to be more actively involved in compensation matters.

Historically, the regulators could always intervene if they thought that the compensation was excessive for safety and soundness reasons.

In October of 2008, the U.S. Treasury issued compensation rules for those companies that had received or would receive TARP funds. These were pretty simple, straightforward rules.

In February of 2009, the stimulus bill was signed into law creating several new compensation rules applicable to TARP recipients.

In June of 2009, the Treasury issued final TARP compensation rules. These rules were much more onerous than those issued in October of 2008. However, under their agreements with the Treasury, TARP recipients were subject to all future rule changes regardless of what they might be. The new TARP rules covered, among other things:

- Clawbacks were required for the top 25 employees (see discussion at page 17)
- Severance could not be paid to the top ten employees (see discussion at pages 18-19)
- Bonuses - no cash only restricted stock in limited amounts - applied to certain senior level employees (see discussion at pages 19-22)
- TARP recipients must allow shareholders to hold Say-on-Pay non-binding vote (see discussion at page 23)
- Annual reports on perqs and compensation consultants were required (see discussion at pages 23-24)
- Annual certifications (see discussion at pages 24-25)
- The compensation committee was given substantial duties (see discussion at pages 15-17)

In October of 2009, the Fed issued for comment proposed guidelines on sound incentive compensation arrangements. These were only for bank holding companies and Fed member banks-coverage for some but not all banking organizations.

In January of 2010, the FDIC sought comment on ways its risk based assessment program could be changed to account for the risks posed by employee compensation programs (the "FDIC Proposal"). This would cover all banks (see discussion at pages 28-32).

In June of this year, the regulatory agencies issued the Regulatory Guidance on Sound Incentive Compensation Policies which became effective on June 25th (the "Guidance"). This covered all banking organizations (see discussion at pages 2-14).

While all this was happening, the regulators were issuing written agreements and C&Ds in record numbers. Historically, these agreements included provisions that required a bank to get approval for the hiring and compensation arrangements for any new senior level employee or an employee being promoted to a senior level position. Regulatory orders are now being issued that, among other things, require banks to develop a written, comprehensive director and executive compensation policy (see discussion at pages 27-28).

The Dodd-Franks Wall Street Reform Act became effective on July 21, 2010. It requires all financial institutions with assets in excess of $1 billion to report the structure of all of their incentive compensation arrangements to the regulators. The regulators are directed to prohibit any incentive based payment arrangement that could encourage inappropriate risk taking by providing excessive compensation or that could lead to material financial loss. This applies to officers, directors and shareholders. The rules must be issued by April 21, 2011.

This paper will review the Guidance, discuss the TARP compensation rules and the Dodd-Franks provision mentioned above, review briefly the FDIC Proposal, the provisions on compensation that are appearing in regulatory enforcement actions and other compensation provisions of the Dodd-Franks legislation that impact public companies.

Regulatory Guidance on Sound Incentive Compensation Policies

General

The Fed, the FDIC, the OCC and the OTS (the "Agencies") issued final guidance governing incentive compensation for banking organizations which became effective on June 25, 2010 (the "Guidance").

The Guidance generally tracks the Fed's proposal in October of 2009. Although the Guidance contains a number of helpful clarifications, it leaves the following principles intact:

- Incentive compensation arrangements should provide employees incentives that balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risk;

- Such arrangements should be compatible with effective controls and risk management so as to better monitor and control the risks these arrangements may create; and

- Such arrangements should be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

Banking organizations must regularly review: (a) incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk; and (b) the risk-management, control, and corporate governance processes related to these arrangements. In addition, they must "immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness."

Larger banking organizations ("LBOs") will have to adhere to more systematic and formalized policies, procedures and processes, while reviews for smaller banking organizations ("SBOs") are expected to be less extensive, formalized and detailed.

The Guidance does not apply to organizations that do not use incentive compensation arrangements.

The Guidance suggests that many SBOs should be able to comply with the Guidance through existing internal controls, audit and governance practices.

With the July 21, 2010 enactment of the Dodd-Franks requiring bank regulators to review compensation arrangements (see discussion at page 26), it is not clear whether the Guidance will be modified or withdrawn.

Regulatory Examinations; Enforcement

Going forward, examiners will review incentive compensation and the results of the review will be included in the ROE. The results will be included in the organization's rating components and subcomponents relating to risk-management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

Enforcement actions may be taken if an organization's incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization. Such action will be pursued when the organization is not taking prompt and effective measures to correct the deficiencies. If material problems are found or the organization fails to promptly develop, submit, or adhere to an effective plan, an Agency may direct an organization to take action, such as developing a corrective action plan that is acceptable to the Agency to rectify safety-and-soundness deficiencies in its incentive compensation

arrangements or related processes. If necessary, an organization may be directed to take additional affirmative actions to correct or remedy deficiencies related to the organization's incentive compensation practices.

Definitions

The Guidance applies to incentive compensation arrangements for covered individuals of banking organizations. LBOs are being treated differently than SBOs as noted below.

Incentive Compensation is defined as current or potential compensation tied to achievement of one or more specific metrics (e.g., sales, revenue, or income). Payments made solely for, and contingent on, continued employment (e.g., salary) are exempted. Furthermore, incentive compensation does not include compensation arrangements that are based solely on the employee's level of compensation and that does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee's salary).

Covered Individuals include the following:

- Senior executives include (a) "executive officers" as defined by the Fed in Regulation O, (b) "named executive officers" of public companies as defined by the SEC in its executive compensation disclosure rules under Item 402 of Regulation S-K, and (c) others responsible for overseeing the organization's firm-wide activities or material business lines.

- Individual employees, including non-executive employees, whose activities might expose the firm to material risk (e.g., traders with large position limits relative to the firm's overall risk tolerance).

- Groups of employees with the same or similar incentive compensation arrangements who, in the aggregate, may expose the firm to material amounts of risk, even if no individual employee is likely to do so (e.g., loan officers who, as a group, originate loans that account for a material part of the organization's credit risk).

In determining the materiality of a risk, a risk should be considered material if it is material to the organization or is material to a business line or operating unit that is itself material to the organization.

Certain employees or categories of employees may be outside the scope of the Guidance if the facts demonstrate that they do not have the ability to expose the organization to material risks; these would likely include, for example, tellers, bookkeepers, couriers, or data processing personnel.

Banking Organizations are defined to mean all banking organizations supervised by the Agencies, including national banks, state member banks, state non-member banks, saving associations, U.S. bank holding companies, savings and loan holding companies, the U.S. operations of foreign banks with a branch, agency or commercial lending company in the U.S., and Edge and agreement corporations.

Large Banking Organizations ("LBOs") are defined as banking organizations supervised by (a) the Fed, large, complex banking organizations as identified by the Fed for supervisor purposes; (b) the OCC, the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (c) the FDIC, large, complex insured depository institutions; and (d) the OTS, the largest and most complex savings associations and savings and loan holding companies.

Smaller Banking Organizations ("SBOs") includes all banking organizations that are not considered to be LBOs under any relevant Agency's standards.

Principles of a Sound Incentive Compensation System

There are three principles for designing and implementing incentive compensation arrangements for banking organizations:

Principle 1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.

Arrangements that provide incentives to employees to increase short-term revenue or profit, without regard to risk, may encourage an employee to pursue opportunities that expose the organization to greater risk.

If an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (e.g., for most employees, organization-wide profit), the potential for the arrangement to encourage the employee to take imprudent risks on behalf of the organization may be weak. Plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees with unbalanced risk-taking incentives. However, this may not be true with respect to other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile. Furthermore, many employees do not believe that their incentive compensation should be based solely on company-wide performance. If an employee has a good year, he or she may not want their compensation tied to the company's profitability.

Plans should be balanced in design and be implemented in a manner so that actual payments vary based on risks or risk outcomes. Employees who are paid

substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected have less incentive to avoid activities with substantial risk. Organizations should not only provide rewards when goals are met, they should also reduce compensation when goals are not met.

Two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. In order to discourage the taking of unnecessary risks, the employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.

All risks associated with an employee's activities should be considered, including but not limited to credit, market, liquidity, operational, legal, compliance and reputational risks. Some risks (or combination thereof) may have a low probability of occurring but should be considered if they would have material adverse effects if the risk were to be realized. Some risks may materialize in the short term while others may be realized only over the long term.

In some instances, future revenues are booked as current income; however, these may not materialize as expected in the future. Moreover, short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (e.g., the higher credit or compliance risk associated with subprime loans versus prime loans). This may happen because the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure.

To address these concerns when developing balanced incentive compensation arrangements, consideration should be given to the full range of current and potential risks associated with the activities of covered employees, including the cost and amount of capital and liquidity needed to support those risks. Reliable quantitative measures of risk and risk outcomes may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced.

In the absence of reliable quantitative risk measures, banking organizations should rely on informed judgments, supported by available data, to estimate risks and risk outcomes and should maintain records supporting these decisions.

LBOs should assess in advance of implementation whether such arrangements are likely to provide balanced risk-taking incentives. Simulation analysis is one way of

doing so. This analysis entails the use of forward-looking projections of incentive compensation awards and payments based on a range of performance levels, risk outcomes, and levels of risks taken. This will provide some guidance to senior management and the board as to both the positive and negative results which could occur.

An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.

The guidance provides tips for making incentive arrangements more sensitive to risk:

- Awards should be adjusted to reflect the level of risk to the organization based upon the employee's activities. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.

- Payouts should be deferred significantly beyond the end of the performance period and the award should be adjusted for subsequent losses during the deferral period. The deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from the activities. In addition, the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.

- Longer performance periods should be used. This is related to the deferral concept mentioned above in that payouts are made only after all risk outcomes are realized or better known.

- Organizations should reduce their sensitivity to short-term performance (aligning payouts with performance). Consideration should be given to reducing the rate at which awards increase as an employee achieves higher levels of the relevant performance measures. By doing so the organization will reduce the magnitude of short-term incentives. This method also can include improving the quality and reliability of performance measures in taking into account both short-term and long-term risks, for example improving the reliability and accuracy of estimates of revenues and long-term profits upon which performance measures depend.

Risk-taking incentives may be materially impacted by performance targets. In some plans, employees may receive greater rewards for increments of performance that are above the target; in others, employees may only receive awards if a target is

met or exceeded. This may motivate employees to take imprudent risk in order to reach performance targets that are aggressive, but potentially achievable.

This list of risk-mitigators is not intended as an exhaustive list; other methods may be used or methods may be combined. Organizations should determine which, if any, of these or other risk-mitigators, are most appropriate to their own situation, compensation philosophy, and goals. These should not be adopted as boilerplate.

Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, an organization should ensure that strong policies and procedures, internal controls, and ex post monitoring of incentive compensation payments relative to actual risk outcomes are in place. These are particularly important to help ensure that the arrangements as implemented are balanced and do not encourage imprudent risk-taking. Managers who are given a great deal of leeway in the compensation setting process should have appropriate information about the employee's risk-taking activities to make informed judgments.

Compensation arrangements constantly evolve. LBOs are expected to actively monitor developments in this area and incorporate into their incentive compensation arrangements any new or emerging methods or practices that are likely to improve a firm's long-term financial well-being, safety and soundness.

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.

The payment of deferred incentive compensation in equity (such as restricted stock) or equity-based instruments (such as options) may be helpful in restraining the risk-taking incentives of senior executives and other covered employees whose activities may have a material effect on the overall financial performance of the organization.

Lower-level employees, however, may not see the value in equity-related deferred compensation because they may doubt their actions could affect the stock price; such compensation, therefore, may not be as effective in restraining the incentives of lower-level covered employees to take risks. In addition, lower level employees would probably prefer cash bonuses. Similar problems could exist for senior officers of an organization whose equity is not widely traded.

To address these issues, organizations are encouraged not to use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive. As a consequence, incentive compensation arrangements

should be tailored to specific employees, reflecting the substantial differences between senior executives and other employees, and the needs of the particular organization.

The Guidance strongly suggests that incentive compensation arrangements for senior executives of LBOs be balanced by (a) deferring a substantial amount of awards over a multi-year period to reduce payouts in the event of poor performance; or (b) by making substantial use of multi-year performance periods; or (c) both. It also recommends paying out a significant portion of incentive awards in equity that vests over multiple years, with the amount of equity actually distributed based on the organization's performance over the deferral period. Deferrals for lower-level employees may not be feasible because of their more limited financial resources.

Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.

Payments to an employee (typically a senior executive), upon departure or a change in control (whether in the form of large additional payments or the accelerated payment of deferred amounts) without regard to risk or risk outcomes can provide the employee with significant incentives to expose the organization to undue risk. Because such arrangements may provide for a guaranteed payment without considering the employee's performance, they may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking.

Existing or proposed golden parachutes should be carefully analyzed. In order to mitigate the potential for the arrangements to encourage imprudent risk-taking, balancing features – such as risk adjustment or deferral requirements that extend past the employee's departure – should be considered. The structure and terms of any golden parachute arrangement should not encourage imprudent risk-taking in light of the other features of the employee's incentive compensation arrangements.

It should be noted, however, that employees may not feel that it is appropriate, following a change in control, to allow the new owner to determine whether the employee has met the goals related to the making of deferral payments. This would be especially true if the employee no longer works for the organization.

"Golden handshakes" are arrangements that compensate an employee for some or all of the estimated value of deferred incentive compensation that would have been forfeited upon departure from the employee's previous employment. For LBOs, provisions that require a departing employee to forfeit deferred incentive compensation payments may be weakened if the departing employee is able to negotiate a "golden handshake" arrangement with the new employer.

While a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after

departure (subject to any clawback or provision which prevents an award from vesting), these changes could reduce the employee's incentive to remain at the organization and, thus, weaken an organization's ability to retain qualified talent. Moreover, actions of the hiring organization (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements.

Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.

Communication is important. Employees covered by an incentive compensation arrangement should be properly informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Communications with employees should include, when feasible, examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes with such communications tailored to reflect the sophistication of the relevant audiences.

Principle 2: Compatibility with Effective Controls and Risk Management

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

Employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements so as to increase their own compensation. An employee may also seek to influence the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk in order to increase his pay.

Traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced.

Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.

Organizations should have strong controls governing the process for designing, implementing and monitoring incentive compensation arrangements. These processes should reinforce and support balanced programs (i.e., not be considered a substitute for balanced programs).

Organizations should create and maintain documentation to permit an audit of the effectiveness of its processes. SBOs should include a review of these processes in their framework for compliance (including internal audit).

LBOs should adopt policies and procedures that identify: (a) the roles of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (b) the source of significant risk-related factors into these processes and establish appropriate controls over their development and approval; and (c) the individual and department whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements. Audit, compliance, or other personnel responsible for the LBO's compliance monitoring must conduct regular internal reviews to ensure compliance. The internal audit department of the LBO should separately conduct regular audits that are reported to appropriate levels of management and, where appropriate, to the board.

Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.

Policies and procedures should be adopted that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining imprudent risk-taking. Such involvement will help risk-management personnel properly understand and address the full range of risks that an organization may face. In many situations, risk managers may have insights on the operations of the company that will greatly benefit this process. Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to: (a) reviewing the types of risks associated with the activities of covered employees; (b) approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and (c) analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.

The risk-management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. Furthermore, compensation for such employees should be sufficient to attract and retain qualified personnel with experience and expertise in these fields that is appropriate in light of the size, activities, and complexity of the organization.

The incentive compensation received by risk-management and control personnel staff should not be based substantially on the financial performance of the business units that they review. To help preserve the independence of these employees, their performance measures should be based on the achievement of the objectives of their functions.

Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.

Incentive compensation awards and payments, risks taken, and actual risk outcomes should be monitored to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes or high levels of risk taken. Reports of this monitoring should be provided to appropriate levels of management, including the board of directors when warranted. The monitoring methods and processes should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation.

SBOs or smaller noncomplex organizations that do not rely very much on incentive compensation may be able to monitor such arrangements through normal management processes.

The results of such monitoring should be considered in establishing or modifying incentive compensation arrangements and in overseeing associated controls. An organization should review and revise its incentive compensation arrangements and related controls as needed to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take imprudent risks.

Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

The board should (a) directly approve incentive compensation arrangements for senior executives; (b) approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives; and (c) carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization. The board's oversight should be based on the scope and prevalence of the incentive compensation arrangements. Where appropriate, a board can delegate this function to the compensation committee or another board committee charged with overseeing incentive compensation. This committee should report to the full board.

Organizations that have received TARP funds are subject to the TARP executive compensation rules that impose specific duties on the board of directors or the compensation committee (see discussion at pages 15-17). In addition, companies registered with the SEC will have to make sure that their compensation committees comply with rules that the SEC has to adopt pursuant to Dodd-Franks (see discussion at pages 32-35).

For LBOs as well as to SBOs with significant incentive compensation arrangements, boards/committees are expected to take a much more active role. Boards/committees of these organizations must: (a) actively oversee the incentive compensation arrangements and related control processes; (b) review and approve the overall goals and purposes of the incentive compensation arrangement system; and (c) provide clear direction to management to ensure that the goals and policies are carried out in a balanced manner.

The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.

Boards should review data and analysis from management or other sources of how the design and performance of the incentive compensation arrangements is consistent with safety and soundness. Moreover, incentive compensation arrangements with senior executives and the sensitivity of incentive compensation arrangements to risk outcomes should be clearly monitored by the board.

If clawbacks are used, they should be monitored by the board to determine whether the clawback has been triggered and, if so, implemented as planned.

A board should keep abreast of significant marketplace changes in compensation plan mechanisms and incentives. However, boards must recognize that incentive compensation arrangements at one organization may not be suitable for use at another firm because of differences in the risks, controls, structure, and management among firms.

LBOs as well as to SBOs with significant incentive programs must review: (a) on at least an annual basis, assessments by management (which includes appropriate input from risk-management personnel) of the effectiveness of the design and operation of the incentive compensation arrangements in providing appropriate risk-taking incentives that are consistent with the safety and soundness of the organization; and (b) periodic reports that assess incentive compensation arrangements and payments relative to risk on a backward-looking basis to determine if risk-taking is being promoted by such arrangements and on a forward-looking basis (using simulation analysis) based on a range of indicators.

The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.

The board should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope and complexity of the firm's activities. This expertise may be collective, may come from outside consultants or may come from formal training or experience. Less complex firms may not need such internal or external expertise. The board should give due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence.

LBOs and SBOs with significant incentive programs should either establish a separate compensation committee consisting solely or predominately of independent directors or ensure that non-executive directors are actively involved in this process. The committee (or non-executive directors) should work closely with any board-level risk and audit committees where the substance of their actions overlaps.

Organizations that have received TARP funds are subject to the TARP executive compensation rules that impose specific duties on the board of directors or the compensation committee (see discussion at pages 15-17). In addition, companies registered with the SEC will have to make sure that their compensation committees comply with rules that the SEC has to adopt pursuant to Dodd-Franks (see discussion at pages 32-35).

A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.

Shareholders should receive appropriate information concerning: (a) incentive compensation arrangements for all employees; and (b) the related risk management, control and governance processes. This will allow them to monitor such processes and, when appropriate take actions to restrain the potential for such incentive compensation arrangements to encourage employees to take imprudent risks.

Large banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.

LBOs should take the following steps:

- Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks (including "covered employees");

- Identify the types and time horizons of risks to the organization from the activities of these employees;

- Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take imprudent risks;

- Include balancing elements, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities;

- Communicate to employees how their incentive compensation arrangements or payments will be adjusted to reflect the risks of their activities to the organization; and

- Monitor incentive compensation arrangements, payments, risks taken, and risk outcomes for these employees and modify the relevant incentive compensation arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

Ongoing Supervisory Initiatives

The Fed has completed its first round of horizontal review and delivered assessments to the 25 affected firms that include analysis of their current incentive compensation arrangements and areas that need prompt attention. The Fed found multiple deficiencies. These banks have been notified by the Fed and are submitting plans outlining steps and timelines for addressing outstanding issues to ensure their incentive compensation arrangements do not encourage excessive risk-taking. Many of the firms had failed to update their practices and were using a one-size-fits-all approach without differentiating between the type and the duration of the risk.

For SBOs, the Fed is gathering information from regularly scheduled examinations and the normal supervisory process. The Fed's focus is to identify the types of incentive plans in place, the job types covered and the characteristics, prevalence and level of documentation available for those incentive compensation plans. For SBOs, the expectation is that there will be very limited, if any, targeted examination work or supervisory follow-up. The policies and systems necessary to monitor these arrangements are expected to be substantially less extensive, formalized and detailed than those of LBOs.

Treasury Final Rule on
Executive Compensation Limits for TARP Recipients

General

In February of 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 ("ARRA"), which further limits executive compensation for financial institutions receiving assistance under the Troubled Asset Relief Program ("TARP") enacted in the Emergency Economic Stabilization Act of 2008 ("EESA"). ARRA amended Section 111 of EESA by modifying the TARP executive compensation rules included in Section 111 of EESA and adopting certain aspects of the rules set out in the Treasury rules implementing Section 111 of EESA (which were issued on October 14, 2008 and January 16, 2009). ARRA directed the Treasury to establish standards for executive compensation and corporate governance for TARP recipients.

On June 10, 2009, Treasury released an Interim Final Rule setting forth these standards. The Interim Final Rule supersedes all prior rules and guidance under the rules previously adopted by the Treasury.

The Interim Final Rule became effective on June 15, 2009, except for those sections of ARRA which were by their terms effective on February 17, 2009.

Scope of Rules

The executive compensation and corporate governance requirements under the Interim Final Rule apply to any entity that has received or will receive financial assistance provided under TARP.

These rules apply only during the time the TARP recipient has outstanding obligations to the federal government arising from its financial assistance (the "TARP Period"). They do not apply if the Treasury is only holding warrants to purchase common stock.

The Interim Final Rule defines financial assistance to include direct financial transactions between Treasury and private sector participants in programs under TARP. Entities that do not engage in financial transactions with Treasury as a counterparty generally will not be deemed to be receiving "financial assistance."

Financial institutions that sold (or will sell) preferred stock to Treasury through the Capital Purchase Program are deemed to have received now (or will be deemed to have received at the time of a future sale) financial assistance; as a consequence, they are subject to the provisions of the Interim Final Rule.

Persons Covered

These rules apply to senior executive officers ("SEOs") and certain most highly compensated employees. SEOs are to be determined pursuant to the executive compensation rules contained in Item 402 of Regulation S-K under the federal securities laws, which apply to the principal executive officer ("PEO"), the principal financial officer ("PFO"), and the three most highly compensated executive officers (other than the PEO and the PFO). The determination of the three most highly compensated executive officers and the most highly compensated employees for a particular year is to be based on their annual compensation for the last completed fiscal year (as it is determined pursuant to Item 402(a) of Regulation S-K).

An employee who is not an executive officer may be a most highly compensated employee. A former employee who is not employed by the TARP recipient on the first day of the fiscal year for which the determination is being made is not a highly compensated employee for that fiscal year, unless such employee is reasonably anticipated to return to employment with the TARP recipient during the fiscal year.

A TARP recipient that does not have securities registered with the SEC must use the same rules when identifying its SEOs and its most highly compensated employees.

Limitation on a TARP Recipient's Compensation Tax Deduction

Section 111(b)(1)(B) of EESA provides that a TARP recipient will be subject to the provisions of Section 162(m)(5) of the Internal Revenue Code of 1986, as amended; this provision limits the deduction for compensation paid to SEOs to $500,000 (including performance based compensation). This rule was implemented as part of EESA in October of 2008 and was not impacted by the ARRA amendments.

Compensation Committee

Section 111(c) of EESA, as amended by ARRA, requires that TARP recipients have a compensation committee that:

- is comprised entirely of independent directors; and
- meets at least semiannually to discuss and evaluate employee compensation plans in light of any assessment risk posed to the TARP recipient by such plans.

If a recipient (including a private company) does not have a compensation committee, it must establish a compensation committee before the later of ninety days after the closing date of the financial assistance agreement between Treasury and the TARP recipient or September 13, 2009.

TARP recipients that do not have securities registered with the SEC and have received less than $25,000,000 in financial assistance may either establish a compensation committee of independent directors or delegate to the board of directors the duties of the compensation committee.

The Interim Final Rule imposes several requirements on the compensation committee.

The compensation committee must review at least every six months with senior risk officers SEO compensation plans and all employee compensation plans and the risks these plans pose to the TARP recipient. In this review, the committee must identify and limit: (i) the features in the SEO compensation plans so they do not encourage SEOs to take unnecessary and excessive risks that could threaten the value of the TARP recipient; and (ii) any features in employee compensation plans that pose risks to the TARP recipient to ensure that it is not unnecessarily exposed to risks, including any features in these SEO compensation plans or employee compensation plans that would encourage behavior focused on short-term results rather than long-term value creation.

The compensation committee must also review at least every six months the terms of each employee compensation plan in order to eliminate the features in a plan that could encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of employees.

Narrative. The compensation committee must annually prepare a narrative description of how (i) SEO compensation plans do not encourage SEOs to take unnecessary and excessive risks that could threaten the value of the TARP recipient, including how these SEO compensation plans do not encourage behavior focused on short-term results rather than long-term value creation, (ii) the risk posed by employee compensation plans were limited to ensure that the TARP recipient is not unnecessarily exposed to risks, including how these employee compensation plans do not encourage behavior focused on short-term results rather than long-term value creation, and (iii) the TARP recipient has ensured that employee compensation plans do not encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of employees.

Annual Certification. The compensation committee must certify annually that the committee has reviewed:

- with senior risk officers the SEO compensation plans and has made all reasonable efforts to ensure that these plans do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the TARP recipient;

- with senior risk officers the employee compensation plans and has made all reasonable efforts to limit any unnecessary risks these plans pose to the TARP recipient; and

- the employee compensation plans to eliminate any features of these plans that would encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of any employee.

Reporting of Narrative and Certification. Most SEC registered TARP recipients must provide the narrative disclosure and the certification in their annual compensation committee report.

TARP recipients that are smaller reporting companies (as defined in the SEC rules) or that do not have securities registered with the SEC must provide the disclosures and certifications annually to their primary regulatory agency and to the Treasury.

Clawback

As required by Section 111(b)(3)(B) of EESA, as amended by ARRA, the Interim Final Rule provides that a TARP recipient must recover any bonus, retention award or incentive compensation paid to (or accrued for) SEOs and the next 20 most highly compensated employees if the payments or accruals were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria (the "Clawback"). A TARP recipient must exercise its Clawback rights unless it determines that it is unreasonable to do so (e.g., the costs of recovery exceed the amount involved).

Bonuses, retention awards, and incentive compensation are deemed paid or accrued when the covered person obtains a legally binding right to that payment during the TARP Period.

The EESA Clawback provision:

- applies to the PEO and the PFO and the three most highly compensated executive officers and the next twenty most highly compensated employees in the company;

- applies to public and private TARP recipients;

- applies to retention awards;

- is not exclusively triggered by a requirement to prepare an accounting restatement due to material noncompliance of the issuer as a result of misconduct;

- does not limit the recovery period; and
- covers not only material inaccuracies relating to financial reporting but also material inaccuracies relating to other performance metrics used to calculate bonus payments.

This Clawback provision differs from the Sarbanes-Oxley clawback provision which requires the forfeiture by a public company's chief executive officer or the chief financial officer of any bonus, incentive-based, or equity-based compensation received during the twelve-month period following a materially non-compliant financial report and any profits from sales of the company's securities during that period.

Severance Prohibited

The Interim Final Rule (as directed by Section 111(b)(3)(C) of EESA, as amended by ARRA) prohibits TARP recipients from making golden parachute payments (defined in Section 111(a)(2) of EESA as any payment for "departure from a company for any reason, except for payments for services performed or benefits accrued") to a SEO or any of the next five most highly compensated employees.

A golden parachute payment includes a payment for departure from a TARP recipient for any reason, other than a payment for services performed or benefits accrued, including an amount due upon a change in control of the TARP recipient.

The acceleration of vesting due to a termination or a change in control is also a golden parachute payment.

There is no longer any exception for any amount of a golden parachute payment as was allowed under the EESA rules adopted previously by Treasury in October of 2008.

Furthermore, a golden parachute payment is treated as paid at the time of the employee's departure, regardless of when the amounts are actually paid (and includes the present value of the payment if vesting was accelerated).

TARP recipients and employees may not avoid the restriction by deferring payment of the golden parachute payment past the end of the TARP Period.

Exceptions to Severance Prohibition. The rules do not prohibit payments from qualified retirement plans, or payments due to an employee's death or disability, as well as severance payments required by state statute or foreign law. A payment will be treated as a payment for services rendered or benefits accrued if the payment would be made regardless of whether the employee departs or a change in control occurs.

A payment from a benefit plan or a deferred compensation plan is treated as a payment for services performed or benefits accrued and, therefore, will not be deemed a golden parachute payment if the following conditions are met:

- the plan was in effect at least one year prior to the employee's departure;
- the payment is made pursuant to the plan and is made in accordance with the terms of the plan as in effect no later than one year before the departure and in accordance with any amendments to the plan during this one year period that do not increase the benefits payable thereunder;
- the employee has a vested right, as defined under the applicable plan document, at the time of the departure or the change in control event (but not due to the departure or the change in control event) to the payments under the plan;
- benefits under the plan are accrued each period only for current or prior service rendered to the TARP recipient;
- any payment made pursuant to the plan is not based on any discretionary acceleration of vesting or accrual of benefits which occurs at any time later than one year before the departure or the change in control event; and
- with respect to payments under a deferred compensation plan, the TARP recipient has previously recognized compensation expense and accrued a liability for the benefit payments according to GAAP or segregated or otherwise set aside assets in a trust which may only be used to pay plan benefits, except that the assets of this trust may be available to satisfy claims of the TARP recipient's creditors in the case of insolvency and payments pursuant to the plan are not in excess of the accrued liability computed in accordance with GAAP.

Limits on Bonuses, Retention Awards and Incentive Compensation

The Interim Final Rule prohibits TARP recipients from paying or accruing any bonus, retention award, or incentive compensation to certain highly compensated employees or SEOs. The rule has two exceptions: (1) TARP recipients can pay or accrue such amounts if the amounts are payable as long-term restricted stock, provided that the stock does not fully vest until the repayment of TARP assistance and has a value that is no greater than one-third of the total annual compensation; and (2) TARP recipients can make bonus payments required to be paid under written employment contracts executed on or before February 11, 2009.

The determination of which executives or employees will be subject to these limitations depends on the amount of funds received by the TARP recipient as indicated in the following table. Note that these restrictions are not limited to officers.

TARP Financial Assistance Covered Executives	
<$25,000,000	Most highly compensated employee only
$25,000,000 to <$250,000,000	Five most highly compensated employees
$250,000,000 to <$500,000,000	SEOs and 10 next most highly compensated employees
$500,000,000 or more	SEOs and 20 next most highly compensated employees

Definition of Bonus. Under the Interim Final Rule, a bonus means any payment in addition to any amount payable to an employee for services performed by the employee at a regular hourly, daily, weekly, monthly or similar periodic rate. Generally, a bonus does not include a contribution to a qualified plan, benefits under a broad-based benefit plan, bona fide overtime pay, and bona fide and routine expense reimbursements. The rules also provide guidance as to when a bonus will be deemed to have accrued or have been paid.

The rules are designed to prohibit the payment of a bonus that was not permitted to accrue during the year an employee was covered by the bonus limitation but is paid to the employee in a subsequent year when the employee is not covered by the bonus limitation. To avoid the bonus payment restrictions, the payment may be disguised as some other form of payment such as a salary increase or a stock option grant. In such a case, the payment in the subsequent year may be recharacterized as a bonus payment that was not permitted to accrue in the previous year.

Exclusion of Commission Compensation. Commission compensation for sales to, and investment management services for, unrelated parties are not deemed to be bonuses. This exclusion is designed to address payments to persons working for broker-dealers, investment advisory firms, and insurance companies. These individuals (registered representatives, investment advisors, and agents) typically receive commissions based on the amount of sales of financial products or the value of assets under management. These commission payments are viewed as a component of the

employee's base salary rather than bonus compensation. Consequently, they are not deemed to be a bonus.

However, fees earned from sales to entities within the affiliated group, or resulting from investment banking, or proprietary trading are not considered commission compensation; these fees are included in the definition of a bonus or incentive compensation.

Definition of Incentive Compensation Plan. An incentive compensation plan is defined by reference to the federal securities regulations and includes stock options and stock plans.

This inclusion does not prohibit a TARP recipient from paying salary or other permissible payments in the form of stock (or a stock unit such as phantom stock) or other property, even if the stock (or stock unit) is issued pursuant to a stock plan. The payment may be made in stock (or a stock unit) that is subject to holding periods or transferability restrictions, including restrictions not permitting the stock to be transferred for a specified number of years, until a specified event occurs (such as the employee's retirement, or a specified number of years after an employee's retirement or other termination of employment), or until certain TARP fund repayment hurdles have been met. The payment, however, must represent the payment of salary or another permissible amount and not be a disguised bonus.

Because the stock (or stock unit) or other property is salary, it cannot be subject to a substantial risk of forfeiture or any requirement of future services.

Definition of Retention Award. A retention award is defined as any payment to an employee that is (i) not payable periodically for services performed at a regular hourly, daily, weekly, monthly, or similar periodic rate, (ii) is contingent upon the completion of a period of future service with the TARP recipient or the completion of a specific project or other activity of the TARP recipient, and (iii) is not based on the performance of the employee (other than a requirement that the employee not be separated from employment for cause) or the business activities or value of the TARP recipient.

This definition does not include: (i) a contribution to or payment made from a qualified plan, or a payment from a benefit plan, overtime pay or reasonable expense reimbursement; and (ii) amounts accrued under a nonqualified deferred compensation plan, to the extent the amounts are accrued in the normal course of the employee's service at the TARP recipient, and are not accrued by reason of a material enhancement of such benefits.

Awards granted to new hires, including awards as part of a "make-whole" agreement intended to provide a newly hired employee a continuation of benefits accruing at a prior employer, are deemed to be retention awards.

A deferred compensation plan that is subject to a service vesting period may be a retention award. If an employee continues to accrue, or becomes eligible to accrue, a benefit under a plan the benefits under which have not been materially enhanced for a significant period of time prior to the employee becoming a covered employee (including through expansion of the eligibility for such plan), the benefits accrued will not be a retention award. If the plan is amended to materially enhance the benefits provided or to make such covered employee eligible to participate in such plan, and such benefits are subject to a requirement of a continued period of service, such an amendment will be a retention award.

Long-Term Restricted Stock. The Interim Final Rule states that the value of the long-term restricted stock can be no greater than 1/3 of the employee's total annual compensation. For purposes of determining annual compensation, each equity-based compensation (including the long-term restricted stock grant) will be included in this calculation in the year in which it is granted at its total fair market value on the grant date.

Long-term restricted stock may include both restricted stock and restricted stock units, which can be settled in stock or cash, and which may be designed to track a specific unit or division within a TARP recipient.

Except as described below, the long-term restricted stock cannot fully vest until the repayment of all financial assistance by the TARP recipient.

Furthermore, an employee must provide services to the TARP recipient for at least two years after the grant date of the long-term restricted stock (or stock unit) in order to vest in this stock (or stock unit). However, the award may vest prior to this two year period (but after the TARP Period) due to the death, disability or a change in control.

The Interim Final Rule does not prohibit vesting based on longer service periods or additional performance-based requirements.

Restricted stock may become transferable (or in the case of a restricted stock unit, payable) earlier. For each 25% of the TARP financial assistance which is repaid, 25% of the total long-term restricted stock may become transferable (or 25% of the restricted stock unit may be payable).

In the case of restricted stock (but not a restricted stock unit), the fair market value of the stock may be subject to inclusion in income for income tax purposes before the stock becomes transferable. As a consequence, if this occurs, the rule permits sales to the extent necessary to pay the applicable taxes.

Grandfathered Written Employment Agreements. Excluded from the bonus payment prohibition are amounts to be paid under a valid written employment

contract executed on or before February 11, 2009 if the employee has a legally binding right under the contract to this payment.

Any amendment to the contract to increase the amount payable, accelerate any vesting conditions, or otherwise materially enhance the benefit available will result in the payment being treated as not made under the employment contract executed on or before February 11, 2009.

The waiver by the employee of any benefits available to the employee under the terms of the contract (such as accepting a reduced bonus or extended holding periods) will not result in the payment of other benefits under the contract being treated as made other than under the employment contract executed on or before February 11, 2009.

Anti-Abuse Rule for Bonuses, Retention Awards and Incentive Compensation. To avoid circumvention, the rules prohibit delaying bonus payments until after the employee is no longer subject to the prohibition, or granting retroactive service credits after the employee is no longer subject to the prohibition. If the employee is no longer a covered employee and the employee is paid an amount, or provided a legally binding right to the payment of an amount, based upon services performed or compensation received during the period the employee was covered by the rule, the employee will be treated as having accrued the amount during the period the employee was a SEO or most highly compensated employee. As a consequence, such amounts cannot be paid.

Certain bonus, retention award, or incentive compensation may relate to a multi-year service period, during some portion of which the employee is subject to the prohibition and during some portion of which the employee is not subject to the prohibition. The employee may not accrue a prohibited payment during the portion of the service period the employee was subject to the limitation. The payment must be reduced to reflect at least the portion of the service period that the employee was subject to the prohibition.

Furthermore, a bonus, a retention award, or incentive compensation that an employee accrues while the employee is not subject to this prohibition and is payable at a time when the employee has become subject to the prohibition, may not be paid until the employee is no longer subject to the prohibition.

Limits on Luxury Expenditures

As required by Section 111(d) of EESA, as amended, the Interim Final Rule directs the board of directors of a TARP recipient to adopt an excessive or luxury expenditures policy, file this policy with Treasury and its primary regulator, and post the text of this policy on its Internet website, if the TARP recipient maintains a company

website, before the later of ninety days after the closing date of the agreement between Treasury and the TARP recipient or by September 13, 2009.

The policy must cover, among other things (i) entertainment or events; (ii) office and facility renovations; (iii) aviation or other transportation services; and (iv) other similar items, activities or events.

The policy (1) must identify the types and categories of expenses prohibited or requiring prior approval; (2) include approval procedures for those expenses requiring prior approval; (3) mandate PEO and PFO certification of the prior approval of any expenditures requiring the prior approval of any SEO, other similar executive officers, or the board of directors; (4) mandate prompt internal reporting of any violation of this policy; and (5) require accountability for adherence to this policy.

The board of directors must determine what are excessive and luxury expenditures and establish a set of requirements specific to the TARP recipient under this policy.

If a material amendment is made to the policy it must be provided to Treasury and its primary regulators and it must be posted on the company's website (if it has one) within ninety days.

Shareholder Non-Binding "Say on Pay"

Section 111(e) of EESA, as amended by ARRA, provides that each TARP recipient must allow its shareholders the opportunity to participate annually in a non-binding vote on senior executive compensation. For a public company, this can be accomplished through a non-binding resolution to approve the compensation of executives as disclosed pursuant to the SEC rules which would be voted on by the company's shareholders. Non-public companies do not have to comply with this rule.

The shareholder vote will not be construed as overruling a decision by the board of directors nor does it create or imply any additional fiduciary duty by the board. Furthermore, it does not restrict or limit the ability of shareholders to make other proposals related to executive compensation.

Section 111(e)(3) directs the SEC to issue any final rules and regulations necessary to implement this requirement not later than February 17, 2010.

Additional Requirements

As permitted by Section 111(h) and Section 111(b)(2) of EESA, as amended by ARRA, Treasury established four additional executive compensation and corporate governance standards.

TARP Recipients Receiving Exceptional Assistance. TARP recipients receiving exceptional financial assistance must submit the compensation payments and compensation structures of the SEO and most highly compensated employees subject to the bonus payment limitation, and the compensation structures of all other executive officers and the 100 most highly compensated employees, to the newly created office of Special Master for approval. The compensation structure for employees not subject to the bonus limits does not have to be submitted if a TARP recipient limits the annual compensation for any executive who is not subject to the bonus limitation provision to $500,000, with any additional compensation in long-term restricted stock.

Perqs. A TARP recipient must disclose annually to Treasury and its primary federal regulator any perquisites (as defined in Item 402(c)(2) of Regulation S-K) whose total value exceeds $25,000 provided to the SEOs and next 20 most highly compensated employees. The filing must include the amount and nature of the perquisite and a justification for offering the perquisite (including a justification for all perquisites offered) and must be made within 120 days of the end of the fiscal year.

Compensation Consultant. A TARP recipient will have to disclose annually to Treasury and its primary federal regulator whether the TARP recipient, the board, or the compensation committee has engaged a compensation consultant. This disclosure must include all of the types of services the compensation consultant has provided during the past three years, including any "benchmarking" or comparisons employed to identify certain percentile levels of compensation (for example, other peer group companies used for benchmarking and a justification for using these companies, and the lowest percentile level of other companies' employee compensation considered for compensation proposals) and must be made within 120 days of the end of the fiscal year.

Tax Gross-Ups. TARP recipients are prohibited from providing tax gross-ups or other reimbursements for the payment of taxes to any of the SEOs and next twenty most highly compensated employees relating to any form of compensation, including severance payments and perquisites.

Acquisitions

If a TARP recipient is acquired by an entity that is not a TARP recipient, the acquirer will not be subject to section 111 of EESA, as amended by ARRA, as a result of the acquisition. In addition, the employees of the target who are subject to Section 111 immediately prior to the acquisition who continue employment with the acquirer will no longer be subject to Section 111 of EESA after the acquisition.

Compliance Certifications

Section 111(b)(4) directs a TARP recipient's PEO and PFO (or their equivalents) to provide a written certification of compliance with the provisions of Section 111 of EESA, as amended by ARRA. There are two model forms included in the Final Interim Rule. One must be filed within 90 days of the end of the first annual fiscal year of the TARP recipient during the TARP Period. The second is to be filed within 90 days of the end of any subsequent fiscal year in the TARP Period.

SEC registered TARP recipients must include these certifications on Exhibit 99.1 in their annual report on Form 10-K and to Treasury.

All other TARP recipients must provide these certifications to its primary regulatory agency and to Treasury.

The TARP recipient must preserve appropriate documentation and records to substantiate each certification for no less than six years after the date of the certification, and furnish promptly any documentation and records requested by Treasury.

The Interim Final Rule requires that the PEO and the PFO of the TARP recipient provide the following certifications within ninety days of the completion of each fiscal year any part of which is a TARP Period. These certifications must indicate, among other things, that: (1) the compensation committee has complied with all of its duties; (2) the TARP recipient has complied with the "clawback" rules and with the rules regarding bonuses, retention awards, and incentive compensation; (4) for an SEC registered TARP recipient, it will permit a non-binding shareholder resolution on the SEO compensation disclosures; (5) the TARP recipient has adopted and maintains an excessive luxury expenditures policy; it will disclose the amount, nature, and justification for the offering of any perquisites whose total value exceeds $25,000 for each of the covered employees; and the TARP recipient, the board, or the compensation committee has engaged a compensation consultant, and the services the compensation consultant or any affiliate provided; (6) the TARP recipient has prohibited any tax gross-ups on compensation to the covered employees; (7) the TARP recipient has substantially complied with any compensation requirements set forth in the agreement between the TARP recipient and the Treasury, as may have been amended; (8) the names of the SEOs and most highly compensated employees are set forth in the certification; and (9) the officer certifying understands that a knowing and willful false or fraudulent statement made in connection with the certification may be punished by fine, imprisonment, or both (See, for example 18 USC 1001).

The PEO and the PFO of a TARP recipient receiving exceptional financial assistance must provide additional certifications.

Special Master

For those TARP recipients receiving exceptional assistance, the new compensation structures and compensation payments for SEOs and the most highly paid employees are subject to review and approval by the Special Master.

TARP recipients may seek guidance from the Special Master as to how the rules apply to their particular circumstances, or confirmation that their modified compensation arrangements are compliant. The Special Master will also review bonuses, retention awards, and other compensation paid before February 17, 2009 to SEOs and the next twenty most highly compensated employees, determine whether any such payments were inconsistent with the purposes Section 111 of EESA, as amended by ARRA, or the TARP, or were otherwise contrary to the public interest and negotiate with the TARP recipient and the employee for appropriate reimbursements to the federal government with respect to compensation or bonuses. The principles that the Special Master is required to follow in conducting these reviews are set out in the Final Interim Rule.

Effective Date

The Interim Final Rule became effective June 15, 2009, except with respect to certain sections of the ARRA amendments that were effective immediately upon enactment of the statute (for example, Section 111(d) requiring a nonbinding shareholder vote on executive compensation).

The bonus payment limitations under the Interim Final Rule will not apply to bonuses, retention awards and incentive compensation paid or accrued by TARP recipients or their employees prior to June 15, 2009, and the enhanced golden parachute prohibition will not apply to amounts paid prior to June 15, 2009. Furthermore, the bonus payment limitations under the Interim Final Rule will not apply to bonuses, retention awards and incentive compensation required to be paid pursuant to a written employment contract executed on or before February 11, 2009, that is paid on or after June 15, 2009.

The Special Master may (i) provide an advisory opinion on either or both of these categories of payments, (ii) determine whether such payments are consistent with ARRA or EESA, or otherwise contrary to the public interest, and (iii) seek reimbursement of such payments where appropriate.

The Special Master is instructed to consider any payment made prior to June 15, 2009, or any payment made or that may be made pursuant to a grandfathered arrangement, as part of (i) the Special Master's review of the compensation payments and structures required to be approved by the Special Master for certain employees of TARP recipients receiving exceptional assistance, and (ii) for any advisory opinion the

Special Master may issue with respect to a compensation structure for, or compensation payment to, a TARP recipient employee.

For the period before June 15, 2009, the provisions of the earlier EESA Rules, remain in effect and subject to ARRA and this Interim Final Rule, all contractual provisions to which a TARP recipient agreed prior to the enactment of ARRA or the publication of this Interim Final Rule will continue in effect.

Compensation Provisions Applicable to Public and Private Financial Institutions

Under the recently enacted Dodd-Franks legislation, federal regulators have been directed to issue rules by April 21, 2011 to require that both public and private "covered financial institutions" with assets of $1 billion or more report to their respective regulators the structure of all their incentive compensation arrangements. The rules must prohibit any incentive based payment arrangements that the regulators determine encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss.

These rules will govern incentive compensation plans not only for executive officers, but also for all employees, directors and/or principal shareholders.

"Covered financial institutions" include depository institutions or holding companies and credit unions.

This rule goes beyond what is required by the Guidance discussed above at pages 2-14. It extends to directors and shareholders whereas the Guidance does not apply to them.

With the July 21, 2010 enactment of this provision, it is not clear whether the Guidance (discussed at pages 2-14) will be modified or withdrawn.

Compensation Provisions in Regulatory Orders

Recently, regulators have been including compensation restrictions in regulatory orders even though no compensation issues were raised in the ROE that lead to the regulatory order. An example is set forth below.

Management and Director Compensation

1. Within thirty days, the Board shall designate a committee of two or more independent directors (Oversight Committee) to monitor and coordinate the Bank's compliance with Paragraph 2 below. For purposes of this Agreement, an individual who is "independent" with respect to the Bank shall be any individual who: (a) is not employed in any capacity by the Bank or its subsidiaries, other than as a director; (b) is not related by blood or marriage to any officer or director of the Bank or any of its subsidiaries, and who does not otherwise share a common financial interest with any

such officer, director or shareholder; (c) is not indebted, directly or indirectly, to the Bank or any of its subsidiaries, including the indebtedness of any entity in which the individual has a substantial financial interest; and (d) has not served as a consultant, advisor, underwriter, or legal counsel to the Bank or any of its subsidiaries.

2. Within ninety days, the Bank shall develop a written, comprehensive director and executive compensation policy that complies with all applicable laws, regulations, and regulatory guidance. For the purposes of this Paragraph, "compensation" refers to any and all salaries, bonuses, incentive compensation, deferred compensation, pension benefits, health or welfare plan benefits, post-termination benefits, and director fees. In addition to defining appropriate levels of director fees and executive compensation, the Compensation Policy shall, at a minimum, consider the following:

a. the combined value of all cash and non-cash benefits provided to each Senior Executive Officer (as defined in 12 C.F.R. §563.555) and each Director;

b. a comparison of each Senior Executive Officer's total compensation with the compensation received by officers with similar responsibilities in similar financial institutions based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets; and

c. the financial condition of the Bank.

3. Within one hundred days, the Bank shall submit the Compensation Policy to the Regional Director for review and comment. Upon receipt of written notification from the Regional Director that the Compensation Policy is acceptable, the Bank shall implement and adhere to the Compensation Policy. The Board's review of the Compensation Policy shall be documented in the Board meeting minutes. A copy of the final Compensation Policy shall be provided to the Regional Director within five days after approval by the Board.

Golden Parachute Payments

4. Effective immediately, the Bank shall not make any golden parachute payment (as defined in 12 C.F.R. § 359.1(f)) unless, with respect to such payment, the Bank has complied with the requirements of 12 C.F.R. Part 359.

Employment Contracts and Compensation Arrangements

5. Effective immediately, the Bank shall not enter into any new contractual arrangement or renew, extend, or revise any contractual arrangement relating to compensation or benefits for any director or Senior Executive Officer of the Bank, unless it first provides the Regional Director with not less than thirty days prior written notice of the proposed transaction. The notice to the Regional Director shall include a

copy of the proposed employment contract or compensation arrangement or a detailed, written description of the compensation arrangement to be offered to such director or Senior Executive Officer, including all benefits and perquisites. The Board shall ensure that any contract, agreement, or arrangement submitted to the Regional Director fully complies with the requirements of 12 C.F.R. Part 359, 12 C.F.R. §§ 563.39 and 563.161(b), and 12 C.F.R. Part 570 - Appendix A.

Third Party Contracts

6. Effective immediately, the Bank shall not enter into any arrangement or contract with a third party service provider that is significant to the overall operation or financial condition of the Bank or outside the Bank's normal course of business unless, with respect to each such contract, the Bank has: (a) provided the Regional Director with a minimum of thirty (30) days prior written notice of such arrangement or contract and a written determination that the arrangement or contract complies with the standards and guidelines set forth in OTS Thrift Bulletin 82a; and (b) received written notice of non-objection from the Regional Director. A contract will be considered significant to the overall operation or financial condition of the Bank where the annual contract amount equals or exceeds two percent (2%) of the Bank's total capital, where there is a foreign service provider, or where it involves information technology that is critical to the Bank's daily operations without regard to the contract amount.

Incorporating Employee Compensation Criteria Into The Risk Assessment System

General

In January of 2010, the FDIC sought comments on ways that the FDIC's risk-based deposit insurance assessment system could be changed to account for the risks posed by certain employee compensation programs (the "FDIC Proposal").

The FDIC indicated that it was not seeking to limit the amount which employees are compensated. Instead, it was concerned with adjusting risk-based deposit insurance assessment rates (risk-based assessment rates) to adequately compensate the DIF for the risks inherent in the design of certain compensation programs. The FDIC hoped to provide incentives for institutions to adopt compensation programs that align employees' interests with the long-term interests of the firm and its stakeholders, including the FDIC.

Certain compensation programs can increase losses to the DIF as they provide incentives for employees of an institution to engage in excessive risk taking which can ultimately increase the institution's risk of failure. In 2009, there were 49 Material Loss Reviews completed that addressed the factors contributing the losses resulting from financial institution failures - 17 of these reports (35%) cited employee compensation practices as a contributing factor.

The FDIC's goals included:

- Adjusting the FDIC's risk-based assessment rates to adequately compensate the DIF for the risks presented by certain compensation programs.

- Using the FDIC's risk-based assessment rates to provide incentives for insured institutions and their holding companies and affiliates to adopt compensation programs that align employees' interests with those of the insured depository institution's other stakeholders, including the FDIC.

- Promoting the use of compensation programs that reward employees for focusing on risk management.

The FDIC indicated that it was not seeking to impose a ceiling on the level of compensation that institutions may pay their employees. Rather, the criteria would focus on whether an employee compensation system is likely to be successful in aligning employee performance with the long-term interests of the firm and its stakeholders, including the FDIC.

Compensation programs that meet the FDIC's goals may include the following features:

1. A significant portion of compensation for employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals should be comprised of restricted, non-discounted company stock. Such employees would include the institution's senior management, among others. Restricted, non-discounted company stock would be stock that becomes available to the employee at intervals over a period of years. Additionally, the stock would initially be awarded at the closing price in effect on the day of the award.

2. Significant awards of company stock should only become vested over a multiyear 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.

3. The compensation program should be administered by a committee of the Board composed of independent directors with input from independent compensation professionals.

Firms that would be able to attest that their compensation programs include each of the features listed above present a decreased risk to the DIF. Consequently, they would face a lower risk-based assessment rate than those firms that could not make such attestation. Firms that cannot attest that their compensation programs

include each of these features could present an increased risk to the DIF. Therefore, they would face a higher risk-based assessment rate than those firms that do make such attestation.

The FDIC requested comment on all aspects of the proposal to incorporate employee compensation criteria into the FDIC's risk-based assessment system, including comments on the FDIC's stated goals and the features of compensation programs that meet such goals. These comments should be reviewed to get a feel for the FDIC's thinking in this area. With the enactment of the Dodd-Franks provision requiring the regulators to look at incentive compensation issues (see discussion at page 26), the FDIC Proposal as well as its request for comments should provide some insight into the FDIC's thinking in this area.

The FDIC invited comment on the following:

1. Should an adjustment be made to the risk-based assessment rate an institution would otherwise be charged if the institution could/could not attest (subject to verification) that it had a compensation system that included the following elements?

    a. A significant portion of compensation for employees whose business activities can present significant risk to the institution and who also receive a portion of their compensation according to formulas based on meeting performance goals would be comprised of restricted, non-discounted company stock. The employees affected would include the institution's senior management, among others. Restricted, non-discounted company stock would be stock that becomes available to the employee at intervals over a period of years. Additionally, the stock would initially be awarded at the closing price in effect on the day of the award.

    b. Significant awards of company stock would only become vested over a multi-year period and would be subject to a look-back mechanism (e.g., clawback) designed to account for the outcome of risks assumed in earlier periods.

    c. The compensation program would be administered by a committee of the Board composed of independent directors with input from independent compensation professionals.

2. Should the FDIC's risk-based assessment system reward firms whose compensation programs present lower risk or penalize institutions with programs that present higher risks?

3. How should the FDIC measure and assess whether an institution's board of directors is effectively overseeing the design and implementation of the institution's compensation program?

4. As an alternative to the FDIC's contemplated approach (see question 1), should the FDIC consider the use of quantifiable measures of compensation-such as ratios of compensation to some specified variable-that relate to the institution's health or performance? If so, what measure(s) and what variables would be appropriate?

5. Should the effort to price the risk posed to the DIF by certain compensation plans be directed only toward larger institutions; institutions that engage only in certain types of activities, such as trading; or should it include all insured depository institutions?

6. How large (that is, how many basis points) would an adjustment to the initial risk-based assessment rate of an institution need to be in order for the FDIC to have an effective influence on compensation practices?

7. Should the criteria used to adjust the FDIC's risk-based assessment rates apply only to the compensation systems of insured depository institutions? Under what circumstances should the criteria also consider the compensation programs of holding companies and affiliates?

8. How should the FDIC's risk-based assessment system be adjusted when an employee is paid by both the insured depository institution and its related holding company or affiliate?

9. Which employees should be subject to the compensation criteria that would be used to adjust the FDIC's risk-based assessment rates? For example, should the compensation criteria be applicable only to executives and those employees who are in a position to place the institution at significant risk? If the criteria should only be applied to certain employees, how would one identify these employees?

10. How should compensation be defined?

11. What mix of current compensation and deferred compensation would best align the interests of employees with the long-term risk of the firm?

12. Employee compensation programs commonly provide for bonus compensation. Should an adjustment be made to risk-based assessment rates if certain bonus compensation practices are followed, such as: awarding guaranteed bonuses; granting bonuses that are greatly disproportionate to regular salary; or paying bonuses all-at-once, which does not allow for deferral or any later modification?

13. For the purpose of aligning an employee's interests with those of the institution, what would be a reasonable period for deferral of the payment of variable or bonus compensation? Is the appropriate deferral period a function of the amount of the award or of the employee's position within the institution (that is, large bonus awards or awards for more senior employees would be subject to greater deferral)?

14. What would be a reasonable vesting period for deferred compensation?

15. Are there other types of employee compensation arrangements that would have a greater potential to align the incentives of employees with those of the firm's other stakeholders, including the FDIC?

New Requirements Under Dodd-Franks Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010. The legislation significantly modifies corporate governance and disclosure practices related to executive compensation.

With the July 21, 2010 enactment of the Dodd-Franks provision requiring bank regulators to review compensation arrangements (see discussion at page 26), an analysis of these provisions may provide some insight into where the regulators might go with the regulations.

Say on Pay

Mandatory Advisory Vote on Pay. Shareholders of public companies must be given a non-binding advisory vote on the compensation of named executive officers (usually the CEO, CFO and next three highest paid officers). This information is contained in the annual meeting proxy statement and is prepared in accordance with the SEC's Compensation Discussion & Analysis rules and related tables ("Say on Pay"). TARP recipients subject to the SEC's rules are already obligated to hold a Say on Pay vote.

Frequency of the Vote. Shareholders will be allowed to determine whether Say on Pay will be voted on annually, biennially or triennially. The first non-binding say on frequency vote must occur in conjunction with the initial Say on Pay advisory vote. This vote must occur once every six years.

TARP recipients subject to the SEC's rules are obligated to hold a Say on Pay vote annually (see discussion at pages 23).

Companies must provide shareholders with the Say on Pay and Say on Frequency vote at the first annual meeting occurring after January 21, 2011 (six months

after the adoption of the legislation). In most cases, these votes will be held at the 2011 shareholder annual meetings of public companies.

The SEC issued final rules on this requirement on January 25, 2011.

Golden Parachutes

In many cases, pursuant to a pre-arranged change-in-control agreement, or pursuant to the merger negotiations, senior officers will receive payments upon the consummation of the sale of the company. Shareholders of public companies will also have a non-binding advisory vote on golden parachute arrangements for named executive officers related to the sale, consolidation or merger of their company. This vote at the transaction-related meeting must be separate from the shareholder vote on the transaction itself. However, a separate vote on a golden parachute is not needed for an arrangement that had already been subject to a shareholder vote at an annual meeting under the Say on Pay requirement. This rule is also effective for January 11, 2011.

The SEC is instructed to provide additional guidance as to exactly what must be disclosed to shareholders when asked to vote on a golden parachute. Additional disclosures are also required in the merger-related proxy solicitation materials including:

- all agreements or understandings with named executive officers concerning any type of compensation (whether present, deferred or contingent) related to the transaction;
- the aggregate total of all such compensation that may become payable to each of the named executive officers; and
- the conditions under which such payments may be made.

Companies currently disclose information related to termination payments for named executive officers, including golden parachute payments, in their annual meeting proxy statements.

The SEC will consider whether smaller companies can be exempted from some or all the Say on Pay and golden parachute voting requirements.

The SEC issued final rules on this requirement on January 25, 2011.

Clawbacks

The national securities exchanges must adopt rules directing listed public companies to implement policies to recover incentive compensation from current and former executive officers if subsequent accounting restatements occur due to a

company's material noncompliance with financial reporting requirements; these policies must also be publicly disclosed by the companies. An executive officer need not be guilty of any wrongdoing in order to trigger the clawback. The amount to be paid back is equal to the extra amount that was paid on the basis of the erroneous data. Amounts are recoverable for the three-year period preceding the date the company is required to prepare the restatement.

These clawback policies go beyond the clawbacks provided for under the Sarbanes-Oxley, which only has a 12-month look back period, covers just the CEO and CFO, and requires misconduct.

A TARP recipient must enforce clawbacks for its 25 most highly paid employees (see discussion at pages 17-18 above).

Additional Executive Compensation Disclosures

The SEC must adopt rules under Item 402 of Regulation S-K requiring public companies to disclose in their annual meeting proxy statements the relationship between the compensation actually paid to executives and the company's financial performance. Such disclosure must take into account any changes in stock value, dividends or other distributions.

Companies will also have to disclose in their annual meeting proxy statements: (a) the median annual total compensation of all employees (except the CEO); (b) the annual total compensation of the CEO; and (c) the ratio between the two. "Total compensation" will be determined under the SEC's rules for the total compensation of the named executive officers in the Summary Compensation Table under Item 402 of Regulation S-K (i.e., the sum of salary, bonus, non-equity incentives, grant date fair values of equity, and "other").

Compensation Committee Independence

The SEC must adopt compensation committee independence standards by July 16, 2011 and direct national securities exchanges to prohibit the listing of any company that does not maintain an independent compensation committee by this date. Companies must be given a reasonable opportunity to cure any noncompliance. When drafting these rules, the SEC has been directed to consider the sources of any additional compensation paid to committee members (including consulting, advisory or other fees) and whether any committee members are affiliated with the company, its subsidiaries or affiliates. Audit committee members must meet similar standards under SEC rules adopted under Sarbanes-Oxley. National securities exchanges may exempt companies in their discretion from the independence standards, based on their size or other factors.

National securities exchanges currently require that compensation decisions for senior officers be made by a committee of independent directors or by a majority of the independent directors if there is no compensation committee.

Just like the audit committee, the compensation committee will have the authority, in its sole discretion, to hire, pay and oversee compensation consultants, legal counsel and other advisers. Appropriate funding to compensate those advisers, as determined by the committee, must be provided by the company.

Compensation Committee Advisor Independence and Disclosure

National securities exchanges will have to enforce rules to be adopted by the SEC (by July 16, 2011), directing that compensation committees when choosing compensation consultants, legal counsel and other advisors, must take into account factors that the SEC will identify as relevant to their independence, including:

- other services provided by the advisor to the company;
- fees received by the advisor as a percentage of total revenue of the advisor's employer;
- the company's policies or procedures designed to prevent a conflict of interest;
- the existence of a business or personal relationship between the advisor and a compensation committee member; and
- any company stock owned by the advisor.

Companies must be given a reasonable opportunity to cure any noncompliance.

Current SEC rules require disclosure about compensation consultants but this disclosure is not as detailed as that required by the legislation.

Effective for proxy statements related to annual meetings occurring on or after July 21, 2011, companies must also disclose whether the compensation committee retained or obtained advice from a compensation consultant, whether such work caused a conflict of interest and, if so, the nature of the conflict and how it was addressed. The SEC may, in its discretion, exempt a category of companies (for example, smaller reporting companies) from these requirements.