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Troubled Asset Relief Program Imposes Minimal Restrictions on Executive Compensation and Corporate Governance

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On October 3, President Bush signed into law the Emergency Economic Stabilization Act of 2008, Pub. L. 110 - 343, § 101 *et seq.* (2008) (the "Act" or "EESA"). This Act empowered the Treasury Secretary to establish the Troubled Asset Relief Program ("TARP"); and, as part of the TARP, to impose certain restrictions on executive compensation and corporate governance. This article briefly examines the restrictions on executive compensation and corporate governance that have been imposed by the Treasury as part of the TARP program.

One aspect of the TARP, called the Capital Purchase Program ("CPP"), provides for the purchase by the Secretary of troubled assets. *See* 73 Fed. Reg. 62,205 (Oct. 20, 2008) (to be codified at 31 C.F.R. pt. 30). While Treasury has committed substantial funds to the CPP, use of TARP has expanded to include other forms of market intervention, including the purchase of equity stakes in banks and, more recently, loans to the automakers.[1]

At present, restrictions on executive compensation and corporate governance appear to apply only to the CPP. Compensation and governance restrictions are imposed on financial institutions "that sell troubled assets to the Secretary under this Act." EESA § 111 (a).

Within the CPP, TARP has different requirements depending on whether the purchase price for a troubled asset is set by a bidding process or by the Treasury. Assets purchased through a bidding process are referred to as auction purchases while other acquisitions are referred to as direct purchases. There are fewer restrictions imposed in cases where the price is set by auction. In cases where the price is set by auction and where "such purchases per financial institution in the aggregate exceed $300,000,000, the Secretary was directed only to prohibit golden parachutes. *See* EESA § 111(c).

The Restrictions

The Act specifically requires that entities from which assets are directly purchased be subject to "appropriate standards for executive compensation and corporate governance." EESA § 111(b)(1). These "appropriate standards" are to be determined by the Secretary of the Treasury. However, the Act did set forth three specific criteria:

1. Limits on compensation to exclude incentives "for senior executive officers" from taking unnecessary and excessive risks that threaten the value of the financial institution during the period the government holds an equity or debt position. EESA § 111(2)(A).

2. "A provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate." EESA § 111(2)(B).

3. A prohibition on golden parachutes to senior executive officers during the period that the government holds an equity or debt position. EESA § 111(2)(C).

As of October 20, 2008, the "appropriate standards" were set forth in the Treasury's Tarp Capital Purchase Program, Interim Final Rule. 73 Fed. Reg. 62,205 (Oct. 20, 2008) (to be codified at 31 C.F.R. pt. 30) (comments to this interim rule are being posted at www.regulations.gov).

This rulemaking authority of the EESA was an invitation for significant regulation by Treasury but, surprisingly,

[1] On October 14, 2008, Secretary of the Treasury Paulson and President Bush separately announced revisions in the TARP program. The Treasury will buy equity stakes in nine American Banks, and potentially thousands of smaller banks, using the first $250 billion dollars allotted to the program. *See* Mark Landler, *U.S. Investing $250 Billion to Bolster Banks; Dow Surges 936 Points*, N.Y. Times, Oct. 14, 2008.

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Treasury's interim rules do not limit financial institutions as much as the Act allows. The Act's prohibition on incentive compensation agreements, described in paragraph (1), is a good example. Treasury was tasked with creating regulations that would exclude incentives for taking unnecessary risks. However, the promulgated rules actually require little more than self monitoring by the affected businesses. Pursuant to the CPP regulations, a financial institution's compensation committee is instructed to review senior executive officer ("SEO") incentive compensation arrangements with the institutions senior risk officers "to ensure that the SEO incentive compensation arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution." 73 Fed. Reg. 62,205, 62,209 (Oct. 20, 2008) (to be codified at 31 C.F.R. pt. 30). Thereafter, the committee must confer annually with senior risk officers to "review the relationship between the financial institution's risk management policies and practices and the SEO incentive compensation arrangements." *Id.* Finally, the compensation committee must periodically certify that it has completed these reviews. *Id.* Specifically, the institution must certify, using words to this effect, that:

> The compensation committee certifies that it has reviewed with senior risk officers the SEO incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution.

Id.

Conspicuously absent from this regulation is any attempt by Treasury to define what constitutes "unnecessary and excessive risks." Instead, Treasury is proposing to require that institutions engage in a process of reflecting on SEO incentive packages. There is some considerable justification for this approach; as the interim rule points out, "each financial institution faces different material risks given the unique nature of its business and the markets in which it operates." *Id.* Therefore, it may make sense to forego defining, in the regulations, what constitutes inappropriate risks. Nevertheless, the regulation appears to fall somewhat short of its mandate to "require that the financial institution meet appropriate standards for executive compensation and corporate governance." EESA § 111(b)(1). In any event, the interim regulation should not prove onerous to financial institutions.

Finally, the Act clearly contemplates the potential for standards beyond those three specifically set forth in the Act. As indicated, the standards to be promulgated "shall include" limits on compensation incentives, a provision for the recovery of bonuses, and a prohibition on golden parachutes. *See* EESA § 111(b)(1). Nevertheless, Treasury chose not to impose any additional restrictions. The interim regulation focuses on the monitoring system intended to limit excessive risk, the bonus claw back provision, the exclusion of golden parachutes, and the technical aspects of implementing these provisions.

Conclusion

There are good reasons for Treasury's limited use of its rulemaking authority in this situation. Most significantly, the Treasury Department may not know enough about individual businesses to justify more invasive restrictions. A conservative approach that allows it to revisit these issues in the future may be appropriate. Whether this conservative approach will work remains to be seen. The bottom line, from the perspective of those institutions selling troubled assets, is that these regulations are far less restrictive than they could have been. ◆

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