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Surviving a Regulatory Storm: Executive Compensation Issues in the Current Economic Crisis

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The financial crisis and economic stabilization legislation are having wide-reaching effects in the financial services sector and beyond. One of the clear outcomes is a fast-moving storm of new restrictions on executive compensation that's barreling toward the U.S. coastline.

An immediate impact will be felt by financial services companies that accept relief under the Emergency Economic Stabilization Act that was signed into law October 3. These organizations will have to come to terms with the effects of new pay restrictions for their senior executives (defined as CEO, CFO and three other highest-paid proxy-named executives or equivalent for private companies). The restrictions are likely to create significant internal equity issues among senior leaders in companies participating in the bailout and may make it more difficult for these organizations to attract and retain senior executive talent, although the full magnitude of the impact won't be known for several months when more guidance is issued.

Whether this regulatory surge will wash over other parts of corporate America remains to be seen. Nevertheless, we believe that all companies, regardless of industry, should begin to prepare for the possibility of higher tax rates and greater regulation of executive compensation. The exact nature and magnitude of these changes will be shaped by the outcome of the Presidential and Congressional elections in November, but they seem likely to occur in some form regardless of the election results. At a minimum, we think companies should prepare for the possibility that they may be required to conduct nonbinding annual shareholder votes on their executive compensation (so-called "say on pay") and may face some tightening of existing pay regulations under Sections 162(m) and 280G, as well as Sarbanes-Oxley.

In the near term, companies affected by the market and economic downturn, regardless of sector, should evaluate whether their outstanding stock options and incentives continue to support key retention and motivational needs. Longer term, all companies should carefully evaluate each element of their pay program for senior officers to ensure that all facets of the program are aligned with the interests of the company's owners. Most companies by this point have devoted a lot of attention to "getting the upside right" — appropriately aligning pay with performance when the company and its stock do well. Relatively few have concentrated as much on the downside. Compensation committees should look especially hard at anything that could be seen as providing "pay for failure" — such as certain severance benefits or employment agreements that guarantee large bonuses for fairly modest short-term results — and institute appropriate restrictions and clawbacks to address any potential excesses.

In today's unsettled environment, all companies would be well-served to examine any executive pay programs and features that might be lightning rods for criticism. Here's a closer look at the critical executive compensation issues facing many U.S. companies today, both in financial services and in other industries.

NEW RULES FOR FINANCIAL SERVICES FIRMS RECEIVING AID

The compensation restrictions in the Emergency Economic Stabilization Act apply to financial institutions that sell troubled assets to the U.S. federal government. The Act's provisions bar senior executives at institutions benefiting under the legislation (in most cases the CEO, CFO and three other highest-paid policy-making executives) from receiving certain forms and levels of compensation. Here's a high-level overview of the new requirements.

Tightening up existing requirements

Some of the new restrictions toughen existing requirements. For example, the 162(m) limits on the corporate tax deduction for executive compensation have been made stricter to:

- lower the maximum, per-executive corporate tax deduction from \$1 million to \$500,000
- subject the CFO's pay to the deduction limit
- subject covered executives to the deduction limit even after they cease to hold roles or receive pay at a level that would make them subject to 162(m)
- eliminate the exemption for performance-based compensation (so stock option gains, incentive payouts, etc., would become subject to the deduction limit).

Likewise, the golden parachute penalties under 280G have been changed to apply to certain circumstances not involving a change in control, such as terminations connected with a bankruptcy, liquidation or receivership, or other involuntary terminations. These penalties (20% excise tax and loss of corporate deductibility) will apply only to the company's CEO, CFO and three other highest-paid executives.

These restrictions apply to any institution — publicly owned or private — that takes advantage of the bailout and sells the government aggregate assets of more than \$300 million that are priced by auction. The special rules are temporary, and many expire by October 2010 at the latest, although the expiration dates vary somewhat by provision.

Moving to uncharted regulatory ground

In situations where the government buys financial assets without bidding or market pricing, additional new corporate governance restrictions apply during the period of the government's investment:

- Both public and private companies will be prohibited from providing incentives for the top five officers to take "unnecessary and excessive" financial risks. (The nature of such risks is not defined.)
- These companies will also be required to claw back bonuses and incentive pay of the top five officers if their financial statements are later found to be "materially inaccurate."
- Finally, these companies will not be permitted to provide golden parachute payments to any of the top five officers. (The term "golden parachute" is not defined for this purpose.)

In addition, in situations where the government buys at least \$300 million of a company's assets via an auction process, the company can enter into no new employment contracts that provide golden parachutes (again, not defined) in the event of involuntary termination, bankruptcy, insolvency or receivership (this applies until at least December 31, 2009).

Many of the details about these new restrictions will remain unclear until additional guidance is issued. The Act requires at least some guidance to be provided by December 3, 2008.

BROADER STORM CLOUDS BREWING?

Even before the adoption of the Emergency Economic Stabilization Act, there was growing pressure on Congress to rein in executive pay in some fashion. While it's impossible to predict exactly when and how such legislation might evolve, the path this storm takes seems likely be affected by the outcome of the upcoming elections. Even before the latest turmoil in the financial markets, it was looking like "say on pay" legislation was becoming more likely, perhaps forestalling more direct regulation of pay.

But with the Stabilization Act now imposing new and significant restrictions on pay and corporate tax deductions for pay in companies that sell troubled assets to the government, many companies are wondering if broader pay regulation might be next. At a minimum, Congress might revise 162(m) at some point to subject CFOs to deduction limits and continue executives' 162(m) status even after they lose proxy-named status.

While certainly not out of the question, it seems doubtful that Congress will eliminate or cut back on the performance-based exemption, since doing so could result in pay compression within the executive ranks and prompt companies to move toward more fixed compensation (instead of variable performance-based pay), as well as other possible distortions. It's less clear whether Congress will see fit to lower the deduction limit below the current \$1 million or subject nonpublic companies to the deduction limits.

Congress might also consider altering 280G to expand the circumstances that could give rise to golden parachute penalties and/or remove the 280G exemption for some nonpublic entities.

Finally, taking a cue from the Stabilization Act and Sarbanes-Oxley, Congress may move for broader application of the requirement that companies claw back income from three additional executives beyond the CEO and CFO in the event corporate financial statements are found to be "materially inaccurate."

As is often the case, however, Congress risks doing more harm than good when it meddles with the market forces that shape executive pay. The lawmakers' track record on pay regulation certainly hasn't been very impressive. In fact, many critics of pay legislation have pointed to 280G and 162(m) as fueling the growth of executive pay, rather than restraining it. By defining a minimum threshold for "excess parachutes" (i.e., three times an executive's prior pay level), 280G undoubtedly contributed to pulling many less generous parachutes up to (or, more precisely, just below) this level. Similarly, by making stock options exempt performance-based compensation under 162(m) — along with the fact that options were then "free" from an expensing standpoint — the lawmakers helped pave the way for options to fuel much of the growth in pay in the 1990s bull market. Only time will reveal any unintended consequences of the new Section 409A requirements for deferred compensation programs (other than a massive compliance burden).

In our view, a better approach for regulating pay is via a sound governance model — holding boards of directors accountable for their pay decisions. If Congress feels a need to go further than basic governance precepts, it should focus on approaches that don't ignore the existence of a competitive labor market for executive talent. Such approaches could involve greater transparency about the pay-setting process (via expanded public disclosures) and/or greater shareholder input into program design (e.g., via nonbinding shareholder votes about pay) as well as input concerning who serves on compensation committees.

PREPARING FOR THE FLOOD

In the current environment, there is plenty of suffering to go around. Both investors and taxpayers have lost real money. Employees are fearful and hurting. All expect executives to share their pain.

Except possibly for a company's top performers, it probably won't be possible to keep people whole or to put the regulatory genie back into the bottle. Unfortunately, it may be time for many to swallow some tough medicine. All signs on the horizon point in the same direction: There will be less pay, more taxes and more regulation. More than ever, compensation committees need to keep their eye on what's important. They need to view rational investors as their owners, not their enemy.

During the go-go days and beyond, pay for performance mostly meant getting the upside right. The downside was mostly an afterthought. Although performance often looks different in a rearview mirror, companies need to give more attention to avoiding pay for failure.

As a result, many compensation committees will want to revisit the downside part of their pay programs over the weeks and months to come. Tally sheets will help answer some — but not all — of their questions. Another part of the answer must come from examining and developing a point of view on what you will do, might do and will never do related to issues such as:

- severance and change-in-control features
- death benefits (so-called golden coffin arrangements)
- hiring features and guarantees
- policies on repricing options
- policies on clawbacks
- the role of restricted stock
- policies on recalibrating performance plans
- perks and executive retirement plans.

Facing a potential storm of criticism and new regulations regarding executive pay practices, companies' natural temptation is often to play defense. We encourage our clients to resist that impulse. Instead, companies should mount a strong offense in the form of sound, well-thought-out and performance-based programs. Those that can point to practices that reflect their mission and values — and align business strategy, financial results, shareholder return and a sound compensation philosophy — are less likely to be attacked in any forum or become lightning rods in the deluge.

Companies should take the threat of more regulation as both a serious wake-up call and a new beginning. Programs that were well designed for a different time and different economic circumstances need to be reconsidered. The storm is about to make landfall. It's a new day.

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