
NYBA

Breakfast Workshop:

Executive Compensation Post Dodd Frank

Key Drivers of Current Compensation Environment

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Overview

- Shifting Landscape
- Shareholder Empowerment
- Regulation of Compensation

Shifting Landscape

- The U.S. bank market is undergoing a radical transformation
- Economic, market and regulatory forces are driving wrenching changes
- The business model of banking is in great flux

Shifting Landscape

- Mortgage lending shocked by: radical changes in securitization market, potential GSE reform, difficult market conditions, changing consumer behavior, politicization
- Consumer lending facing increased regulatory intervention (CARD Act, Durbin, likely more state regulation)
- Wholesale and other businesses impacted by new regulations (e.g. capital, derivatives, Volcker)

Shifting Landscape – M&A

- Many banks have seen their way through financial crisis by raising new capital
- New capital has come through PE investments, blind pools and recaps
- Also well-funded start-ups have entered the market
- These participants are often sophisticated parties who bring with them long-term operators
- While we are seeing a dearth of sellers and transactions are more challenging due to regulatory concerns, the influx of sophisticated parties has resulted in a dynamic deal environment that is giving rise to creative deal structures

Shifting Landscape

Recapitalization

- Pacific Capital (Ford), West Coast (20 investors)
- Sterling (TH Lee, Warburg Pincus + others)
- Central Pacific (Carlyle, Anchorage + others)
- Capital Bank (NAFH), Cascade (Lightyear, Leonard Green, WLRoss)

FDIC Assisted

- IndyMac (Dune/Flowers)
- BankUnited (WLRoss/Blackstone/Carlyle/Centerbridge)
- Premier American (Bond Street)
- MetroBank (NAFH)

Bank acquisitions

- Cadence (Community Bancorp - Steel/Harrison/Murphy)
- Bank Midwest (NBH)
- AmericanWest (SKBHC - Kisting/Oaktree/GS/FF&L)

Minority investments

- Webster (Warburg Pincus)
- National Penn (Warburg Pincus)

Startups

- Fieldpoint

Shifting Landscape – Bottom Line

- Community banks are not sleepy anymore
- Complicated institutions that require sophisticated portfolio management
- Many smaller institutions are engaged in transactions once reserved for larger institutions
- These transactions require involvement of those with transactional and operational expertise
- This has resulted in higher pay at such institutions
- In addition, institutions with PE money have imported to the industry their brand of compensation – highly leveraged, equity-based, pay for performance model, 8-20 percent of the company for management
- We expect industry-wide changes in pay structures reflective of this changing dynamic

Shareholder Empowerment

- Issue that has directly influenced pay for public companies
- Has indirectly influenced compensation at private companies
- Movement driven by increased influence of institutional investors
- Results from increased AUM of such institutions
- Many such institutions have interests in addition to, or distinct from, corporations whose stock they own

Shareholder Empowerment – Majority Voting

Majority Voting

- In uncontested elections directors were historically elected by plurality vote
- “Majority voting” in director elections has become the norm – adopted by approximately 77% of S&P 500 companies
 - Majority voting provisions require that in uncontested elections directors be elected by a majority of votes cast
 - Incumbent directors who are not reelected by a majority vote must tender resignations
 - Delaware courts will generally defer to a board’s business judgment and apply the “business judgment rule” in assessing a board’s rejection of an un-elected director’s resignation (*Axcelis* - 2010)
- Majority voting gives “teeth” to recommendations by proxy advisory firms to “withhold the vote” for directors

Shareholder Empowerment – Broker Non-Votes

Broker Non-Votes

- Historically, NYSE rules permitted brokers to vote on behalf of clients who failed to provide voting instructions in uncontested director elections
- NYSE Rule 452 now prohibits such broker discretionary voting
- Dodd-Frank eliminates broker discretionary voting for certain matters (election of a director, executive compensation or “any other significant matter” as determined by the SEC)
 - Makes it more difficult to achieve majority votes in uncontested director elections
 - Increases the voice of activist shareholders
 - Enhances power of proxy advisory firms such as ISS

Elimination of Classified Boards

- Generally, in a classified board, one-third of the directors are elected each year for three-year terms
- Declassification proposals (requiring all directors to be elected annually) continue to be pushed by activists
- Percentage of S&P 500 companies with classified boards has been steadily declining: 25% in 2011 (down from 47% as recently as 2005)
- In 2011, shareholders at 40 companies voted on proposals seeking board declassification – proposals averaged 71% shareholder support
 - Management at 45 companies initiated declassification proposals in 2011 – these proposals averaged 98% shareholder support
- Immediate or phased declassification

Shareholder Empowerment – Say on Pay

Say on Pay

- Dodd-Frank requires a nonbinding shareholder vote at least every 3 years to approve named executive officers (NEOs) compensation and a nonbinding shareholder vote at least once every 6 years to determine the frequency of “say-on-pay” votes (SOP)
- At a significant majority of companies, shareholders have opted for an annual SOP vote
- In 2011, approximately 39 companies’ SOP proposals did not receive majority support
 - Shareholders have brought derivative suits against several companies that failed to receive majority support alleging breach of fiduciary duties
 - Delaware law protects directors who adopt compensation programs in good faith (*Goldman Sachs* – 2011)
- Even though SOP passed at 98.5% companies, many companies have changed compensation practices to help ensure they don’t receive a “no” vote
- Moreover, fear over losing SOP has led many public companies to engage in dialogues with significant shareholders
- In many instances, dialogue has focused on performance and strategy more than pay

Regulatory Developments -- TARP

TARP

- Treasury originally invested \$205B in 707 institutions
- Through 11/3, Treasury received \$210.3B in repayments and income
- Through 11/3, Treasury now has \$17.3B in outstanding CPP capital investments in 387 institutions
- This tells us three things:
 - Scope of TARP has waned
 - But 387 institutions still covered, and
 - Most remaining covered institutions are smaller institutions
- Some companies exiting through M&A and are able to avoid compensation restrictions through such exits

Regulatory Developments -- – Dodd Frank

- Say on Pay – has had significant influence already in way that companies pay executives
- Clawback – listed companies must have clawback policy for incentive compensation of executive officers if an accounting restatement required due to material noncompliance with financial reporting requirements
- Disclosure -- Mandatory annual proxy disclosure regarding the relationship between executive compensation and the company's financial performance, the company's policies regarding employees and directors engaging in hedging transactions on company stock, and the ratio of the median annual total compensation of the company's employees (excluding the CEO) to that of the CEO
- Compensation committees – committees may select consultants only after taking into consideration competitively neutral independence factors determined by the SEC
- These Dodd-Frank requirements (other than SOP) are subject to future SEC rulemaking

Regulatory Developments – Interagency Guidance

- Interagency guidance bolstered by Dodd-Frank prohibits financial institutions from maintaining for “covered persons” any incentive-based compensation arrangements (ICAs) that encourage inappropriate risks by providing excessive compensation.
- Excessive compensation means amounts that are unreasonable or disproportionate to, among other things, the nature, quality and scope of the services performed.
- ICAs should be supported by strong corporate governance and effective controls and risk management
- “Covered persons” includes executive officers, directors, employees and principal shareholders.
- While all employees are potentially covered persons, intended to apply to covered persons or groups of covered persons that encourage inappropriate risk to the covered financial institution.
- Companies should maintain flexibility in the design of their incentive compensation arrangements in order to accommodate the final rule and should consider creating a working group to develop a compliance action plan.

Adding It Up – Cross-Currents

- Shifting landscape and re-alignment of industry creates both uncertainty and opportunity
- Introduction of PE pay structures in financial institutions context creates potential for large and leveraged pay packages
- Shareholder empowerment, regulatory developments and changes in the nature of the banking business makes careful design essential
- Increased regulation of compensation means that there must be a greater dedication of resources to compliance
- While regulation may chill certain pay practices, many exceptions to these regulations in the M&A context