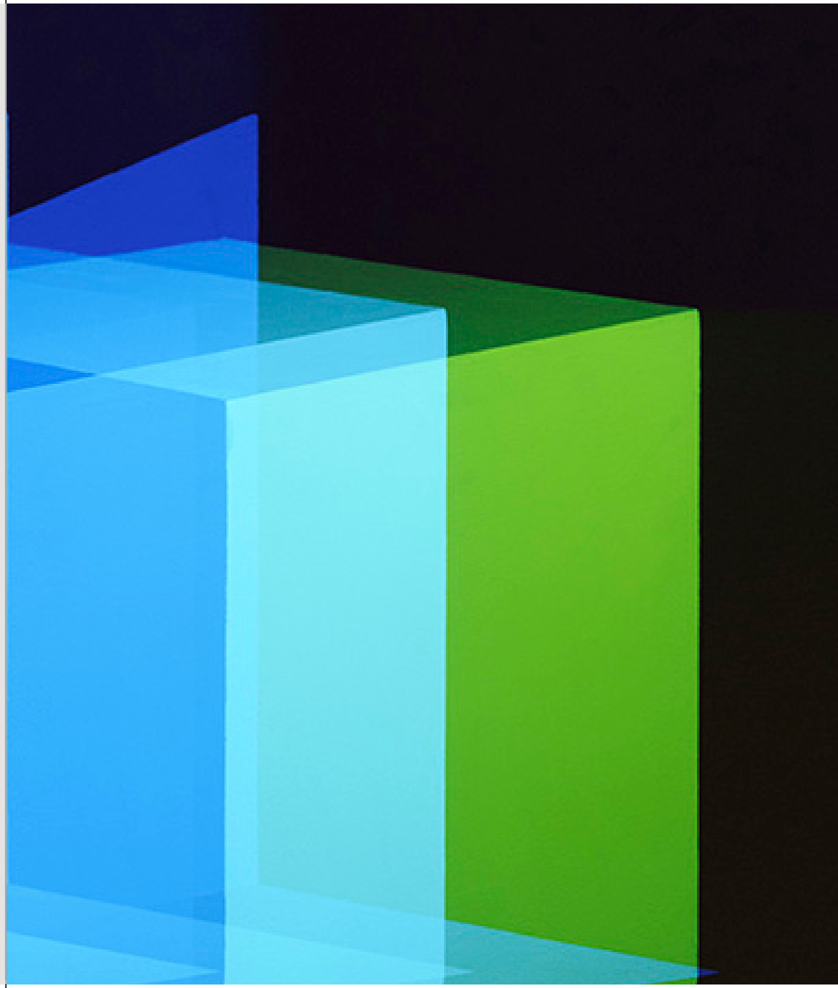
SEMLER BROSSY

Remembering TARP:
The Executive Compensation Guidelines

MANAGEMENT REFERENCE DOCUMENT

MAY 2020



Timeline of 2007-09 U.S. Financial Crisis including Executive Pay Developments

Credit crisis spreads to global markets

- Demand for subprime mortgage-backed securities dries up; lenders begin to file for Chapter 11 bankruptcy
- Stock market peaks (October)
- Home sales plummet
- Fed cuts rates 1.0% over a 3-month span

Fed begins bailouts

- Tax rebate bill and stimulus for banks and fails to stabilize housing market
- Bear Stearns and Countrywide acquired
- Fed holds unprecedented emergency meeting and halves rates

Fed puts out fires as financial institutions fail

- Fannie Mae and Freddie Mac nationalized
- Lehman Brothers falls, sparking a crash in oil, money markets and equity markets
- WaMu and Indymac fail after bank runs
- Fed buys AIG and offers protection for Goldman Sachs and Morgan Stanley to become bank holding companies
- Fed insures money market accounts and injects liquidity to avoid a feared credit market collapse

TARP created to unfreeze credit markets and bailout financial institutions

- TARP allows Treasury to buy troubled assets from financial institutions; executive pay limits required
- TALF created to secure and boost consumer lending
- Automobile execs first outside of finance to seek TARP access; Treasury obliges under enhanced conditions
- Equity markets crash further; Fed rate hits zero

And then it got worse

- Stock market bottoms as unemployment spikes, GDP contracts -6%, and TARP recipients are reportedly hesitant to lend
- Obama signs $787B stimulus into law ("ARRA"), including tax cuts, unemployment benefits, and public works funding
- ARRA includes additional executive compensation restrictions
- "TARP bonuses" (bonuses given to bankers receiving taxpayer assistance) drive public outcry against executive pay

Relative calm as markets rebound

- First bank stress test results announced; mixed results
- Treasury clarifies and amends ARRA's executive compensation restrictions for TARP recipients
- Treasury appoints Kenneth Feinberg as "Special Master for Executive Compensation," responsible for overseeing TARP pay, with particular influence at seven companies receiving "exceptional" assistance

Beginning of return to normalcy

- Record foreclosures continue as banks resist lending and loan modifications, but commit to more lending in 2010
- Feinberg announces executive pay determinations for top executives at "exceptional" TARP assistance companies
- TARP wind-down begins as unemployment peaks; many banks commit to accelerating repayments
- The Fed was ultimately repaid $377B of the $412B it disbursed through TARP (excluding mortgage programs), and ultimately profited when considering further gains realized on bank shares it later sold

RESTRICTION MILESTONES

Progression of Executive Pay Restrictions in the 2007–2009 Financial Crisis

PAGE

October 2008

Congress authorizes TARP, includes executive pay standards

- TARP initially intended for financial institutions only, before Automobile executives asked to participate
- Institutions receiving funds must comply with specified executive compensation standards
- Banks receiving TARP funds draw criticism for paying year end bonuses to employees

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February 17th, 2009

ARRA stimulus signed into law with new, broad pay restrictions

- Feinberg appointed “Special Master” to oversee executive pay at TARP institutions
- Institutions receiving “exceptional” assistance subject to particularly strict limitations

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2009 and beyond

Lingering impact on executive pay

- Financial crisis and outrage over bonuses and approved pay for TARP executives drove a reexamination of executive pay and how Boards approached it
- While TARP generally lowered executive pay, Feinberg’s approval of large (>$5M) pay packages at bailed out companies suggests the Treasury was sympathetic to talent retention concerns
- Pay principles developed and refined during crisis become common, usher in Dodd Frank (2010)

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OCTOBER 2008

Initial TARP Restrictions

TARP was initially described by the Treasury as funds to help bolster banks in tough times. Most banks participating sold the Treasury preferred shares with yields that increased over time. About half of initial funding went to nine of the larges financial institutions, and the rest was split between smaller banks. Chrysler and GM later joined at their own request.

All participants agreed to the following TARP compensation restrictions until they repurchased their preferred shares:

Prohibition of Risky Incentives

- Institutions would be required to ensure that senior executive incentive compensation did not encourage inappropriate risk that would threaten the institution's value
- Requires the Compensation Committee to review Senior Executive (i.e., CEO, CFO, and three next most highly paid) incentive plans within 90 days and to certify having done so in the CD&A

Potential Clawback of Bonuses

- Institutions would need to have the ability to recover any senior executive incentive compensation that was paid based on earnings, revenues or gains later proved inaccurate

No Golden Parachutes

- Golden parachutes for senior executives capped at 3x the executive's "base amount" (i.e., 5 year average compensation)

$500K Limit on Deductible Compensation

- Executive compensation in excess of $500,000 would not be deductible for federal income tax purposes (reduced from $1M limit under 162m)

Additionally, Chrysler and GM agreed to **divest their corporate jets** and make **incentive compensation for their 25 highest paid executives subject to government approval**

FEBRUARY 17, 2009

ARRA Restrictions *(later clarified in June)*

President Obama's bailout program, ARRA, included compensation rules that meaningfully exceeded prior TARP restrictions. ARRA controversially applied retroactively to TARP participants, upsetting many banks who may not have accepted funds under its new terms. ARRA did not cap salary for most institutions, however.

PAY TOPIC	RESTRICTIONS (GENERALLY IN EFFECT UNTIL TARP FUNDS WERE REPAID)
Limits on compensation	• Prohibition on bonuses and stock options (unless contractually grandfathered); salary uncapped • Restricted stock awards (minimum two year vest) capped at 50% of salary • Covers executives beyond Top 5 based on level of TARP funding; covers Top 25 for most large companies
Other pay restrictions	• Prohibition of tax gross ups for the Top 25 executives • Prohibition of compensation plans (at any employee level) that "encourage the manipulation of earnings"
Clawbacks	• Applies to Top 25 highest paid executives and is triggered by payments found to be based on performance later found to be inaccurate • Applies to incentive compensation (i.e., total annual pay minus salary)
Golden Parachutes	• Severance prohibited for Top 6 executives

FEBRUARY 17, 2009

ARRA Restrictions *(later clarified in June)*

(cont'd from page 13)

PAY TOPIC	RESTRICTIONS (GENERALLY IN EFFECT UNTIL TARP FUNDS WERE REPAID)
Review of Prior Payments	• Newly appointed "Special Master" Feinberg will retroactively review compensation for Top 25 executives, and negotiate reimbursement for any payments found to be "contrary to the public interest," which is defined with principles (e.g., pay should promote long term performance and minimize excessive risk)
Say on Pay	• Vote required annually
Disclosure	• Companies must disclose to the Treasury (i) the use of a compensation consultant, and (ii) any perquisites over $25K offered to executives, with a corresponding justification
Tax Deductibility	• Capped at $500K/year for each Top 5 executive

ARRA also included Risk assessments and Luxury expenditure rules that were substantively unchanged from prior guidance

ARRA Restrictions:
“Exceptional Financial Assistance” Company Pay Outcomes

The seven institutions (AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial) receiving “exceptional assistance” under TARP faced more severe pay restrictions in addition to being subject to the other ARRA rules. In particular, pay levels and structures for the top 100 executives were subject to direct control by the Special Master Kenneth Feinberg.

Review and Approval of Payments:
the Special Master was required to review and approve any payment of compensation to the Top 100 highest paid executives of these companies

- Executives 26 100 may be excluded if total pay (except long term restricted stock) is determined below $500K

Feinberg made additional principles based determinations for executive pay, including:

- Significantly reduced total compensation, especially in cash, including a targeted $500K cash cap
- For the Top 25, replace salary with immediately vesting stock required to be held until TARP repayment
- Require a majority portion of pay to take a long term focus (e.g., 3 year holding periods), including incentive grants that are contingent on objective performance goals
- Prohibited growth in supplemental retirement plan values, and, in severance accruals for the Top 20 execs
- Exceptions (i.e., larger pay packages) could be made “where necessary” to protect taxpayer interests

Feinberg’s pay determinations led to the following average outcomes:

- Top 25 cash compensation down more than 90%, and below $500K for >90% of covered employees
- Top 25 average total compensation down more than 50%; but 84% of executives were retained through year end
- Bank of America accelerating its TARP repayment to escape the pay restrictions before year end
- Chrysler keeping pay below $500K for all 26–100 executives to escape restrictions

Enduring Impact:
Dodd Frank Wall Street Reform and Consumer Protection Act

Dodd Frank was born out of the financial crisis and placed major regulations on the financial industry, with the intention of preventing the collapse of major financial institutions. The financial crisis and the compensation provisions included in the Act have had an enduring impact on executive compensation processes and design.

A massive piece of legislation: 2,000+ pages requiring 400 new rules on many different topics. Eight of these are executive compensation provisions that apply to all industries

- 40% of rules have not been finalized as of April 2020, and some may never be

Some of the executive pay provisions did not have a clear link to the Act's stated intention (e.g., Say on Pay; CEO Pay Ratio disclosure rules)

- Economic crises always result in regulation and reform
- Some politicians, as well as members of the media and public, believed executive pay had become excessive, encouraged excessive risk taking (and in some cases financial reporting fraud), and that oversight beyond the Board was required due to Board failure in governance
- Some speculate that the Act was simply the most convenient opportunity to enact executive pay provisions

Pay provisions ushered in a new era for executive compensation. Say on Pay in particular has led to pay structures that reflect principles made prominent by the financial crisis and TARP restrictions

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CASE STUDY | J. P. MORGAN

Executive Compensation Before vs. After TARP

J.P. Morgan was subject to the 2008 TARP (page 4) and 2009 ARRA (page 5-6) executive pay restrictions. The company repaid its $25B of TARP funds prior to year end 2009 pay decisions. The company's executive pay followed a fairly typical pattern for the time: pay levels were high in 2007, slashed in 2008, and rebuilt quickly thereafter.

2007

CEO pay nearly $50MM; average NEO $20.3MM

2008

CEO and several top executives received only salary; no cash or equity incentive pay

- Several NEOs received modest incentive pay
- Proxy disclosure emphasized that pay outcomes reflected annual results far short of goals, but not poor overall performance in the context of the financial environment

2009

Pay after TARP repayment began to bridge the gap back to pre recession levels

- RSUs made up largest component of increase
- CEO did not receive a cash bonus
- One departing executive received all cash

2010

Rising pay levels with a greater emphasis on stability and financial performance

- Greater emphasis on RSUs
- CEO awarded first cash bonus since 2007, at reduced level
- Material increase in senior executive salaries in 2011

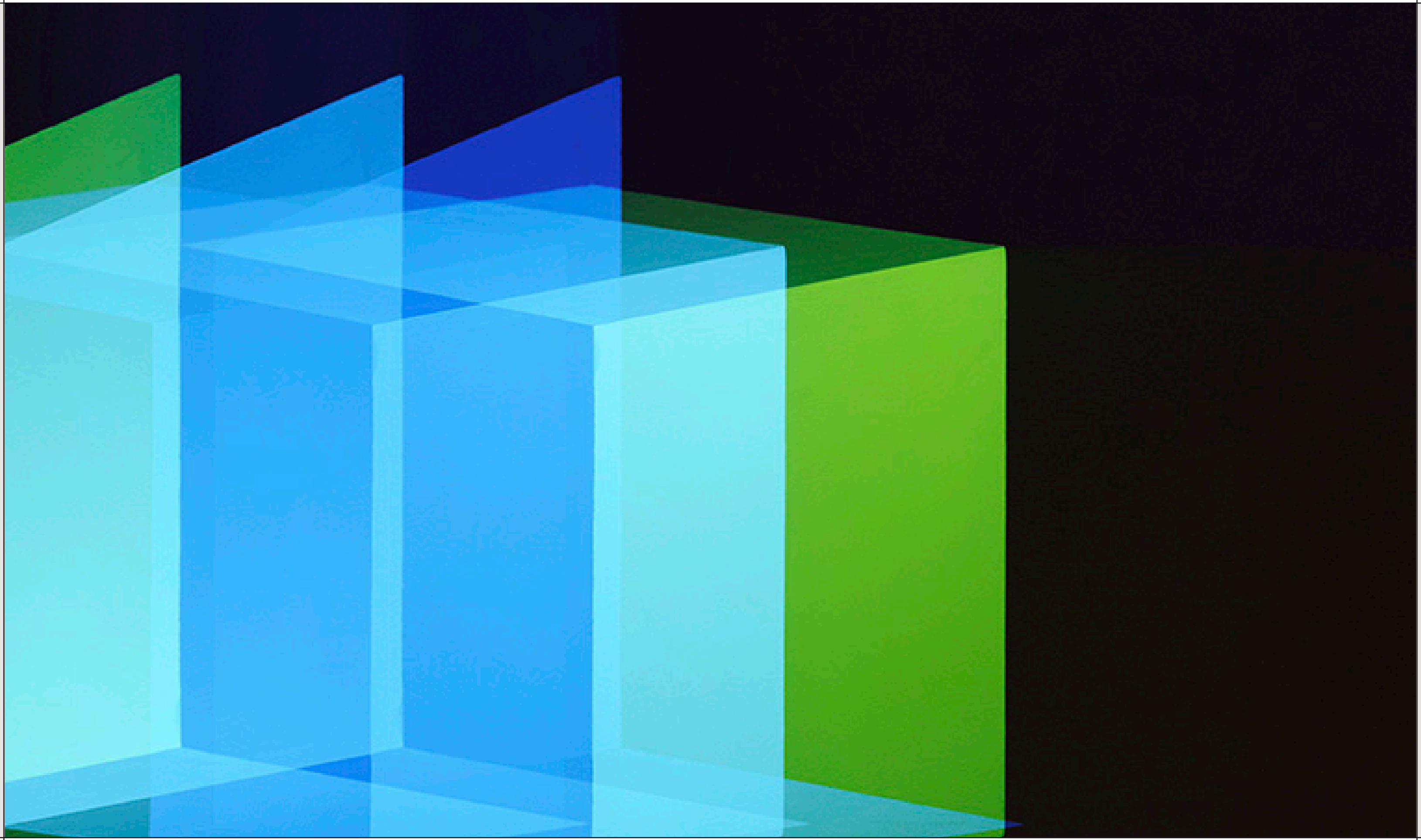
Executive Compensation Before vs. After TARP *(cont'd)*

	YEAR	SALARY ($)	BONUS ($)	STOCK AWARDS ($)	OPTION AWARDS ($)	TOTAL ($)
Jamie Dimon CEO and Chairman	2011	1,500	4,500	12,000	5,000	**23,000**
	2010	1,000	5,000	12,000	5,000	**23,000**
	2009	1,000	0	7,952	6,244	**15,196**
	2008	1,000	0	0	0	**1,000**
	2007	1,000	14,500	14,500	19,868	**49,868**
	2006	1,000	13,000	13,000	0	**27,000**

	YEAR	SALARY ($)	BONUS ($)	STOCK AWARDS ($)	OPTION AWARDS ($)	TOTAL ($)
NEO Average	2011	750	4,400	6,600	1,750	**13,500**
	2010	483	4,207	6,310	1,681	**12,681**
	2009	500	4,948	5,052	1,013	**11,513**
	2008	500	1,063	1,063	4,079	**6,705**
	2007	466	5,588	10,488	3,725	**20,267**
	2006	455	7,225	7,225	544	**15,449**

Figures reflect year end pay decisions for service in the year listed.

We use a constant set of executives between 2006 2009 to provide a more consistent view of the impact of the financial crisis on pay levels. Two Investment Bank co CEOs were not NEOs in 2008 due to lower pay levels but were NEOs in prior and future years.



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