State of Connecticut

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The Honorable Neel Kashkari
Interim Assistant Secretary for Financial Stability
U.S. Department of the Treasury
Office of Financial Institutions Policy
Room 1418
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Comments on the Interim Final Rule on the TARP Capital Purchase Program, 31 C.F.R. Part 30

Dear Assistant Secretary Kashkari:

This letter is in response to the U.S. Department of the Treasury request for comment on the interim final rule, 31 C.F.R. Part 30 (the "Rule"), promulgated pursuant to sections 101(a) (1), 101(c) (5) and 111(b) of the Emergency Economic Stabilization Act of 2008 ("EESA"). The Treasury is to be commended for its stance on the need for restrictions on and greater oversight of executive compensation at companies who receive government assistance under the EESA. However, more can and should be done to clarify and otherwise strengthen various provisions of the rule that, if left alone, could undermine or override its intent and spirit.

As the principal fiduciary of the $26 billion[1] Connecticut Retirement Plans and Trust Funds ("CRPTF"), my primary concern with the Rule is how it would ultimately affect the bottom line for the 165,000 people who depend on the CRPTF for their future retirement security, including Connecticut teachers, municipal workers and state employees. Accordingly, I have long been a strong advocate of performance-based compensation, and believe that appropriate incentives and alignment of management and shareholder interests are critical to the creation of long-term sustainable value by our portfolio companies. In my view, poorly designed executive compensation contributed to the crisis now facing our financial institutions by encouraging excessive risk-taking and a short-term orientation on the part of executives.

Prior to the current crisis, significant corporate governance concerns -- including problems involving executive pay -- were present at many of the 33 companies that

[1] As of the fiscal year ending June 30, 2008.

reportedly have applied to participate in the TARP Capital Purchase Program ("CPP") and whose securities are held by the CRPTF. Specifically, the CRPTF withheld support from directors at eighteen of the 33 companies for reasons including excessive executive compensation, a unified chairman/CEO structure and excessive non-audit consulting fees paid to the outside auditor. It is also worth noting that four of the companies received a "very high concern" rating, and eight received a "high concern" rating, on executive compensation from The Corporate Library. Measures to remedy these dysfunctional governance practices must be a key part of any program that aims to strengthen financial companies using taxpayer money.

For that reason, I agree with the compensation principles articulated in EESA aimed at ensuring that companies participating in the CPP are not permitted to continue the compensation status quo. A break with prior practice is especially important because executives responsible for failed strategies and boards that implemented faulty pay policies may remain in place following the Treasury Department's acquisition of an equity or debt position.

The Rule, however, does not effectively implement EESA's principles of avoiding excessive risk, eliminating "pay for failure" and ensuring that performance-based incentive compensation is truly earned. Without significant changes to both the Rule's substantive standards and the mechanisms used to monitor and enforce compliance with those standards, the compensation provisions will have little or no impact on company behavior.

There are a number of specific actions that the Treasury should take to remedy some flawed provisions of the Rule.

- Define "incentive compensation arrangements" to eliminate uncertainty over which kinds of plans and programs are covered.

- Establish meaningful enforcement of the Rule to ensure that companies do not take on unnecessary and excessive risk.

- Eliminate ambiguity concerning the "clawback" provision and what constitutes "materially inaccurate" financial statements and performance metrics.

- Impose a substantial excise tax on income of covered executives that exceeds the $500,000 threshold.

Following is an explanation as to why I believe these actions are necessary.

First, the Rule provides no guidance as to when an incentive compensation arrangement could lead senior executive officers to take unnecessary and excessive risks that could threaten the value of a financial institution. The Treasury Department appears to shy away from defining this standard in the Rule out of a concern that one size does not fit all.

While it may be the case that some risks will differ, it is also clear that other risks—the use of excessive leverage, for example—were common to many financial institutions before the onset of the current financial crisis. There are also general principles -- such as the importance of not overweighting short-term incentives -- that apply to all financial institutions. Similarly, as compensation consulting firm F.W. Cook & Co. has pointed out, financial goals for compensation may be "so far above the company's past performance as to require performance outside the acceptable risk profile of the company." F.W. Cook also identified overuse of stock options, the absence of equity retention or holding requirements and the inability of the compensation committee to adjust performance to reflect the quality of earnings as potentially risky practices. I urge the Treasury Department to flesh out this standard more fully in the final rule so companies and their advisors can make the necessary changes to compensation plans and practices.

Second, the proposed mechanism for ensuring that companies comply with the requirement that their compensation arrangements do not encourage unnecessary and excessive risk -- basically a self-certification by the board's compensation committee[2] -- leaves this important determination solely in the hands of the very same board members who signed off on poorly-structured compensation programs before the financial crisis. This is unacceptable. It is the responsibility of the Treasury Department to enforce this rule, and a mechanism must be adopted to provide meaningful enforcement.

The Rule should include a procedure by which the Treasury Department is given the power to review companies' compensation arrangements and require changes. Resource constraints may dictate that the Treasury Department confine its review to those companies exhibiting "red flags" suggesting excessive risk in their compensation programs. Third-party certification by an outside expert (e.g., a compensation consultant or accounting firm) that does not have any business relationship with a company could, if designed with appropriate safeguards, supplement or substitute for the Treasury Department's review to some extent. In any event, the self-certification process proposed in the Rule provides insufficient assurance of a robust review.

Third, the "clawback" provision, which states that a financial institution must require recovery of incentive compensation that was based on materially inaccurate financial statements or performance metric criteria, is too vague. It is not clear how materiality would be defined for purposes of the Rule. Companies may assume that the definition tracks that used in the securities law context, where information is material if it "would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available."[3] This standard, which requires intensive factual analysis, is not well-suited for a clawback policy, which needs to be clear and administrable by a company.

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[2] The Rule as proposed would require public companies to include the compensation committee certification in the Compensation Discussion and Analysis ("CD&A") section of the proxy statement. Because the CD&A is a report by the company's management, the Compensation Committee Report in the proxy statement is the more appropriate location for the certification.

[3] Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988).

Further, the Rule does not make clear whether "materially inaccurate" performance metrics denote only targets that were not actually satisfied at the time of original performance measurement or whether the term includes situations where the performance target was satisfied but later developments undermined the achievement. For example, an executive may receive a bonus based on earnings in Year 1, but those earnings are reversed by significant writedowns in Year 3. The final rule should specify whether the Year 1 incentive compensation would be considered to have been based on materially inaccurate performance metrics and whether the analysis would be affected by the Treasury Department having divested itself of its equity or debt position between Years 1 and 3.

The mechanism by which the financial institution must require recovery is left open as well. Is a simple board-approved corporate governance policy sufficient? Or is the financial institution required to establish some other process -- holding back a portion of incentive compensation for a period time, for instance -- that gives greater assurance that amounts can actually be recovered? Can the board retain discretion not to seek recovery if the expected costs outweigh the benefits? I urge the Treasury Department to flesh out what companies must do to comply with this provision and to do so in a way that is consistent with the principles of avoiding excessive risk and "pay for failure."

Fourth, the Rule caps deductible compensation for participating firms at $500,000 and does not exempt "performance-based" compensation meeting certain requirements from this cap as is currently the case under the Internal Revenue Service's regulations. Thus, this provision will impose a hard compensation cap that is quite low in the context of current executive compensation practice. Companies participating in the CPP will undoubtedly face pressure to exceed the $500,000 threshold and will capitulate if they think it is necessary in order to secure or retain skilled executives.

Denying deductibility of all amounts in excess of the threshold if the board chooses to exceed the cap punishes the wrong people—the shareholders—rather than the directors who made the decision to disregard the cap or executives who received the excess compensation. Accordingly, if a cap is retained, I encourage the Treasury Department to impose a substantial excise tax on amounts received above the cap, and to prohibit companies from grossing up executives for this tax liability. Using this mechanism would have the benefit of ensuring that much of the excessive compensation finds its way back into the public treasury.[4]

Finally, I applaud the Treasury Department's effort to limit severance amounts payable to senior executive officers by companies participating in the CPP; as a shareholder, it is galling to see "pay for failure" on the scale we have recently witnessed. I wish, however, to highlight the potential for manipulation resulting from how the provision is drafted.

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[4] Before the final passage of EESA, I expressed my concern regarding the effect of the non-deductibility provision on shareholders in a letter to the Connecticut Congressional delegation that is available on the Office of the State Treasurer's web site (http://www.state.ct.us/OTT/pressreleases/press2008/PR10012008.pdf).

The Rule currently provides that senior executive officers cannot receive a golden parachute payment as defined in the IRS's regulations during the time the Treasury Department holds an equity or debt position in the company if the payment is triggered by an involuntary termination,[5] bankruptcy filing, insolvency or receivership. Experience has shown that where loopholes exist -- as they now do for voluntary terminations and retirement -- companies and executives are likely to alter their arrangements to maximize compensation. Accordingly, the Treasury Department should consider whether disparate treatment of these various circumstances best serves the goals of EESA.

Thank you for the opportunity to share my views with the Treasury Department on this important rulemaking. If you have any questions or need additional information, please do not hesitate to contact me or Meredith Miller, Assistant Treasurer for Policy, at (860) 702-3000.

Sincerely,

Denise L. Nappier
State Treasurer

[5] Certain voluntary terminations—those in which the facts and circumstances indicate that the SEO's service would have been terminated and the SEO knew this to be the case—are also included.