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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Phantom Stock Plans

Phantom stock plans, which are also known as shadow or unit stock plans, are a type of stock based incentive compensation to permit key employees the ability to share in a company's success without giving the employee any actual equity in the business. Phantom stock option plans are generally administered by a committee, selected from non-employee members of the board of directors of the company who will not be participants, that award compensation units to key employees of the company.

The award of units by the administrative committee does not convey any actual ownership in the company. A phantom share unit is a credit in a participant's account for an amount equal to the value of the company's actual shares.

Once the units are awarded to the participant's account, it is credited with changes in share value, along with dividends and other distributions by the company to its stockholders of actual shares. Generally, phantom stock plans provide that dividends and changes in a company's capital structure are taken into account in valuing the participant's interest under the plan. If a dividend is paid on the company's outstanding stock, an equal prorated amount is credited to each unit held by a participant. In addition, if a company changes its capital through a stock split or stock dividend, the number of units held by a participant is adjusted accordingly in proportion to the change.

There is generally no taxable income for the participants in phantom stock plans until units are redeemed in the participant's account. At the same time, there is no tax deduction for the company until it becomes obligated to pay the employee for units held in his account. Payments to participants are taxed at ordinary income tax rates.

Since participants in phantom stock plans do not hold "real" shares or have any actual equity in the company, participants are not eligible to vote at stockholder meetings of the company. Phantom stock plans are ideal and provide flexibility for privately owned businesses, since units awarded to participants do not dilute the ownership interest of stockholders of the company. Phantom stock plans are also attractive to Subchapter S corporations. Under the provisions of the Internal Revenue Code, a Subchapter S corporation can have no more than 100 stockholders and may only have one class of stock. Phantom stock units are not treated as a separate class of stock and do not count toward the maximum number of stockholders.

In Interpretive Letter No. 1087, the Office of the Comptroller of the Currency ("OCC") responded to an inquiry about whether national bank directors may utilize phantom share units to meet the requirement that they own directors' qualifying shares under the requirements of the National Bank Act (12 U.S.C. § 72). The National Bank Act generally requires that every director must own capital stock of a national banking association in which he or she is a director, the aggregate par value of which is not less than $1,000, or an equivalent interest, as determined by the OCC in any company which has control over the national banking association, i.e., a bank holding company. The purpose of the statute is to insure that a national bank director has a financial stake in the operations of a bank (or its holding company) so that the director will have the incentive to be vigilant in protecting the bank's interests.

12 C.F.R. § 7.2005 generally provides that (i) a national bank director must own a qualifying equity interest in common or preferred stock with a value of $1,000 in the national bank or in a company that controls the national bank; and (ii) the OCC may consider whether other interests in a company controlling a national bank constitutes an interest equivalent to $1,000 par value of a national bank's stock.

The OCC noted that the deferred share units, which were issued by the holding company, had characteristics similar to equity holdings and were, in almost all respects, equivalent to common shares of the holding company. The value of the deferred share units was tied directly to the value of the holding company's common shares and accrued dividend equivalents equal to dividends paid on the holding company's common shares. Although the phantom share units had no voting rights, the OCC determined that the units met the requirements for directors' qualifying shares in that each unit tracked the value of the holding company common shares and assured that bank directors had a financial stake in the operations of the bank as evidenced by an equivalent interest in its holding company.

Phantom stock plans are an effective tool in providing incentives for attracting and retaining key employees and directors, while at the same time maintaining the equity interest of the existing shareholders.

Securities Activities of Banks

The Securities and Exchange Commission ("SEC") and the Board of Governors of the Federal Reserve System ("FRB") have adopted joint final rules dealing with the securities activities that banks may engage in without registering as brokers. The original proposal by the SEC to implement provisions of the Gramm-Leach-Bliley Act of 1999 was known as Regulation B and was opposed by federal banking regulatory agencies. The final rules, known as Regulation R, permits banks to continue to conduct securities transactions, subject to certain conditions, for their customers as part of a bank's trust and fiduciary, custodial and deposit "sweep" functions, and to refer customers to a securities broker-dealer pursuant to networking arrangements with broker-dealers without having to register. Regulation R also allows banks to pay more than "nominal" fees to bank employees who refer institutional and high net worth customers to a broker-dealer. A bank will have until the first day of its first fiscal year commencing after September 30, 2008, to comply with Regulation R. Regulation R is available on the web site of the FRB at *www.federalreserve.gov*.