

# Guiding Principles for Enhancing Banking Organization Corporate Governance

**EXPOSURE DRAFT FOR PUBLIC COMMENT**

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**ANNEX A – OVERVIEW OF 2014 UPDATES**

# Preamble to the Exposure Draft

# Preamble to the Exposure Draft (Dated September 10, 2014)

The attached document sets out a series of corporate governance principles (including the commentary which should inform the application of the principles, collectively, the “[Governance Principles](#)”) that The Clearing House Association (“TCH”) believes will be useful for U.S. banking organizations to consider in structuring the manner in which the board of directors of the consolidated bank holding company (“BHC”) carries out its oversight responsibilities. These Governance Principles were initially published in June 2012 with a view to revising them periodically to reflect changes in law, regulation and practice. They are now being republished in updated form on September 10, 2014.

The concept of corporate governance in this context refers to the relationships among the board of directors, management, shareholders and other stakeholders and their respective roles and responsibilities. In developing these principles, TCH considered the collective experience of the BHC governance professionals who are members of the Board and Board committees of TCH, as well as regulatory pronouncements and supervisory guidance, state corporate law, and federal and state banking law. These Governance Principles are intended to help guide BHCs as they deal with corporate governance issues, but are not designed to be prescriptive or to set minimum requirements or best practices applicable to all banking organizations. Each banking organization must tailor its governance practices as it deems appropriate for its own situation. Within that context, any number of individual principles may, in whole or in part, be of less significance or may require adaptation with respect to a particular banking organization.

TCH strongly believes that good corporate governance and effective oversight from a BHC’s board of directors serve the public interest and are essential to both a safe and sound banking system and a profitable enterprise. For that reason, TCH believes it would be useful for banking regulators to consider the proper allocation of responsibility between boards of directors and management in rulemaking and other proceedings.

A central tenet of good corporate governance is the distinction between the board’s responsibility for *oversight* of the business and affairs of the BHC and the board’s delegation to management of the responsibility for the day-to-day *operations* of the BHC. Absent extraordinary circumstances, the board should not involve itself in day-to-day operations as this likely will reduce efficiency, impair the board’s ability to perform its critical oversight role objectively, and create uncertainty as to roles and responsibilities. Indeed, excessive board involvement in

the day-to-day affairs of a banking organization could compromise the board’s independence, which is a hallmark of sound corporate governance.

It is important for board members, shareholders, management and those government officials charged with overseeing banking organizations to recognize and understand this crucial distinction between oversight and management, particularly as increasing demands are made on boards. Regulatory actions that prescribe for a board highly detailed responsibilities, and in some cases also the manner of executing them, can in fact impede directors’ proper discharge of their duties and oversight. Moreover, experience has shown that detailed prescriptions that seem apposite for an issue at a point in time often lose their relevance with changing circumstances.

TCH believes that development of a common understanding of a basic framework for corporate governance will facilitate more effective execution of the board oversight function, enhance bank safety and soundness, promote confidence in banking organizations and encourage consistent supervisory guidance.

TCH recognizes that governance practices are not immutable—rather, they evolve over time in response to market and industry practice, the regulatory and supervisory environment and the collective experiences of market participants. TCH expects to continue to revisit these Governance Principles from time to time to assess whether further changes or updates are appropriate. Readers of these Governance Principles should bear in mind that this document speaks as of its date and should consider the impact of any subsequent developments.

The 2014 update incorporates various legal and regulatory developments and expands on certain topics, including the interplay between traditional state law fiduciary duties and the obligations imposed on boards by banking statutes, regulations and pronouncements; the importance of enterprise-wide risk management and controls within a holding company structure, including the management of the oversight function at the holding company level and the avoidance of duplicative entity-level structures and the importance of the board and senior management establishing a “tone at the top” promoting an enterprise-wide culture of ethical behavior and compliance, including board oversight of a compliance reporting (or “whistleblower”) system. For a more complete list of updates, please refer to **Annex A**.

## **Request for Public Comment**

TCH looks forward to receiving input from all interested parties on this exposure draft. TCH hopes the Governance Principles advance the cause of more effective board oversight of banking organizations.

These Guiding Principles were prepared under the auspices of The Clearing House's Corporate Governance Committee with the assistance of The Clearing House's special counsel, Sullivan & Cromwell, LLP. This version of the Guiding Principles is being published on September 10, 2014, for the purpose of gathering input from all interested parties. The Clearing House requests that any comments be submitted no later than October 31, 2014.

Please send comments to

**Comments@theclearinghouse.org** and include "Guiding Principles for Corporate Governance" in the subject line. ■

# Introduction

# Introduction

The Clearing House Association (“TCH”) has developed these Governance Principles to provide guidance on core corporate governance issues for U.S. banking organizations.<sup>1</sup> These Governance Principles are structured as a set of general principles, supplemented by commentary. The commentary includes considerations that banking organizations may want to take into account to determine the manner in which they will implement the Principles, as well as references to relevant statutes, regulations, case law, supervisory guidance and other source material. The commentary also references academic and supervisory views and various recommendations on corporate governance practices and principles but, unless otherwise noted, TCH is not endorsing the position of these commentators. These Governance Principles have been prepared with the fundamental understanding that no set of practices will necessarily be ideal for all organizations in all ways. Accordingly, they are not designed to constitute “best practices” and, as applied and tailored within a specific complex banking organization, many of these principles may achieve a counterbalancing effect relative to others. Importantly, it should be noted that governance practices evolve over time. TCH updated these Governance Principles in 2014 to reflect changes in the relevant laws, rules, regulations, supervisory guidance and other source material, as well as changes in industry or market practice and in the collective experiences of the TCH owner banks. TCH expects that these Governance Principles will be further updated periodically from time to time.

In the banking industry, boards and management also should respond to the standards and expectations of bank regulators, both at the holding company and the bank level. These are expressed in the form of regulations and supervisory guidance (issued both broadly through manuals and publications and specifically in the course of an organization’s own supervisory discussions and reports), and generally are designed to advance the public interest in maintaining safe and sound financial institutions. Supervisory guidance from bank regulators, in contrast to actual rules and regulations, is not binding, but nonetheless should be considered carefully by banking organizations in light of their particular businesses and circumstances and the context in which the guidance is provided. Any significant deviations from such supervisory guidance should be adopted in a reasoned and transparent manner and, as appropriate, discussed with the relevant regulator. Furthermore, while regulations and

supervisory guidance by bank regulators about corporate governance at the bank level are not determinative for bank holding companies, they can provide important guidance for the boards of bank holding companies.

In recent years, bank regulators have increased their emphasis on corporate governance as a crucial element in promoting safety and soundness. These Governance Principles not only outline key legal and regulatory requirements and guidance but also incorporate enhancements to governance practices that go beyond what is *required* by applicable laws and regulations. These enhancements to the minimum standards prescribed by bank regulations include:

- recommendations for a substantial majority (not just a majority) of independent directors and limited management presence on the holding company board in Section 2;
- a delineation of core elements of the board’s oversight duties and responsibilities in Section 4 (including the establishment of an ethical and compliance-related “tone at the top” and regular board meetings with a discussion focused on risk management, capital planning, resolution plans and liquidity risk);
- a recommendation for board approval (rather than just review) of an organization’s strategic objectives in Section 4;
- recommendations on the need for financial expertise on the audit committee in Section 6;
- the discussion in Section 7 of board diversity;
- the discussion in Section 11 on the need, if the same person serves as both CEO and chairperson of the board, for a lead independent director who will, among other things, preside over executive sessions of independent directors;
- the recommendation in Section 12 that the board articulate an approach for determining what matters should be addressed at the board and committee level;
- the Governance Principle on meetings with bank regulators in Section 15, which contemplates that such meetings should occur at least twice a year; and
- the discussion in Section 16 of the involvement by the board, and in particular the independent directors, in shareholder engagement efforts.

The typical structure contemplated by TCH in these Governance Principles is that of a top-tier public holding

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<sup>1</sup> These Governance Principles are principally designed for U.S. banking organizations because non-U.S. banking organizations (including their U.S. subsidiaries and other U.S. operations) are generally subject to a different set of governing laws, regulations and relationships presenting certain unique issues and considerations not addressed in the Principles.

company with one or more wholly owned subsidiary banks (and typically non-bank subsidiaries). TCH generally designed these Governance Principles to be applicable to a banking organization as a whole, but with the understanding that the interplay between the holding company and the subsidiary bank(s) will vary from organization to organization, and that an identical corporate governance approach often will not apply to both a public holding company and a wholly owned subsidiary. In particular, the governance structure of a holding company organization should reflect the critical responsibility of the board of directors of the subsidiary bank to protect the safety and soundness of the bank. Generally speaking, it should be acceptable for entity-level risk and control functions (including at bank subsidiaries) to be part of an enterprise-wide risk management structure managed at the parent company level, and generally overseen by the parent company board, so long as the system provides for necessary entity-level legal and safety/soundness considerations and board involvement. Where the parent company framework is adequate for the subsidiary, any mandating of duplicative structures can create administrative distraction and inefficiency, as well as confusion, and subvert enterprise-wide risk management.

The statutory and regulatory backdrop for these Governance Principles includes provisions that apply to all publicly owned companies (*e.g.*, state corporate law requirements, Securities and Exchange Commission (“SEC”) rules and securities exchange listing standards) and provisions that apply specifically to bank holding companies and their subsidiary banks (*e.g.*, requirements of federal and state banking law—which often incorporate state corporate law—and supervisory guidance specifically applicable to depository institutions and their affiliates). TCH believes, however, that the principles underlying these governance requirements are broadly consistent and provide a baseline for evaluating practices for the banking organization as a whole. Of course, each entity will need to satisfy all relevant regulatory requirements applicable to that entity.

As noted above, these Governance Principles address corporate governance structures and practices for banking organizations generally. Nonetheless, a hallmark of sound corporate governance is that structures and practices should be tailored as appropriate for the particular entity. U.S. banking organizations have a variety of strategies, business mixes, structures, products, cultures, customer bases and geographies. Within a framework of basic principles, each banking organization should develop the corporate governance structures and practices that best correspond to the needs of the individual organization, taking into account all relevant factors. Accordingly, adherence to a particular structure or practice may not be appropriate for an individual banking organization, though TCH believes that any significant deviations from

these Governance Principles by a banking organization should occur in a reasoned and deliberative manner.

Corporate governance structures and practices are aids to, rather than determinants of, effective corporate governance. Effective corporate governance is ultimately determined by the quality, skills, expertise and judgment, individually and collectively, of the members of the board and the management of the banking organization, and the culture of objective and informed oversight, management integrity, ethical behavior and performance that those individuals foster. ■

# Governance Principles

# Governance Principles

*Note: These principles should be read together with the related commentary set forth in the next section of this document.*

## Section 1. Basic Responsibilities of the Board and Management

- (a) **Under law, the business and affairs of a corporation, including a banking organization, are managed under the direction of a board of directors. The board delegates to a professional and full-time management team the day-to-day operation of the company. This positions the board to provide oversight of—and serve as an independent check on—management. Maintaining a distinction between the respective roles of the board and of management is necessary in any corporation, including banking organizations.**
- (b) **The board is responsible for making certain statutorily identified decisions, for selecting the chief executive officer, and for providing oversight of the business and affairs of a banking organization and its management.**
- (c) **Management is responsible for the day-to-day operations of the banking organization.**

## Section 2. Independence of Board Members

- (a) **A substantial majority of the directors of the top-tier entity within a banking organization should be independent, and only a relatively small number of directors should be members of management.**
- (b) **The board of the holding company should review the composition, including the independence requirements, of the boards of its subsidiary banks.**

## Section 3. Size of the Board

- (a) **The board of the top-tier entity within the banking organization should have the flexibility to determine its own appropriate size and the board size for its subsidiary banks, within any statutory requirements.**
- (b) **The board should be small enough to facilitate effective functioning but large enough to allow members to contribute sufficient knowledge, experience and diversity to the board's oversight role and its committees.**

- (c) **Decisions on board size will depend on a banking organization's particular circumstances, needs and objectives, including:**

- (i) **the nature, scope and complexity of its business;**
- (ii) **the need to meet applicable independence and other regulatory standards;**
- (iii) **the need to provide a range of skills commensurate with the board's oversight role and a diversity of views that can provide necessary insight into the banking organization's multiple constituencies; and**
- (iv) **the ability to staff board committees with a sufficient number of members that meet relevant independence and qualification criteria and the needs of the committees.**

## Section 4. Oversight Duties of the Board

- (a) **The oversight duties and responsibilities of the board of a banking organization should include the following:**
  - (i) **reviewing financial performance, capital adequacy and liquidity on a regular basis;**
  - (ii) **reviewing and approving the organization's strategic objectives and plans on a regular basis;**
  - (iii) **monitoring management performance in formulating and implementing the organization's strategic plans and overseeing key business policies and procedures established by management;**
  - (iv) **setting the ethical "tone at the top" by overseeing the development and implementation of a code or codes of conduct applicable to directors and employees and that addresses treatment of breaches or lapses in ethical behavior, and approving appropriate corporate governance principles and other policies and procedures that position the board to fulfill its duties effectively and efficiently;**
  - (v) **selecting and evaluating the performance and compensation of the Chief Executive Officer ("CEO") and such other senior executive officers as the board deems appropriate;**

- (vi) approving a management succession plan for the CEO and reviewing or approving management succession plans for other senior executive officers;
- (vii) promoting a culture of compliance with applicable laws and regulations, and overseeing management's establishment, implementation and operation of a compliance system, including internal and external audit processes, disclosure controls and procedures, and responses to compliance failures;
- (viii) understanding the organization's risk profile, reviewing the standards for the nature and level of risk the organization is willing to assume in light of the organization's capital and liquidity levels, approving capital plans and resolution plans, reviewing the organization's principal risk management policies and monitoring compliance with the foregoing (including having board meetings at least annually with discussions focused on these issues);
- (ix) reviewing the organization's efforts to meet its community's credit needs, as appropriate;
- (x) reviewing and approving related party transactions; and
- (xi) performing all other oversight duties and responsibilities required by statute, regulation or regulatory orders (including oversight of executive compensation programs, liquidity and stress testing) or that the board deems appropriate from time to time.

- (b) The board may discharge these duties directly or through board committees to the extent permitted by applicable law.
- (c) For subsidiary banks, many of these responsibilities may be discharged by the board of the top-tier entity within the banking organization, depending on the structure of the organization and the judgment of the top-tier board and the subsidiary bank board as to the appropriate allocation of responsibilities (subject in any case to specific regulatory requirements at the subsidiary bank level).

Section 5. Board Committees

- (a) The board of the top-tier entity within a banking organization should establish board committees to assist the board in its oversight of (i) audit,

(ii) nominating/corporate governance, (iii) compensation and (iv) risk management activities, as well as any other standing or temporary committees appropriate to the circumstances and businesses of the banking organization.

- (b) The responsibilities of each standing committee should be described in a written charter or similar document. Certain matters might be within the scope of two or more committees (e.g., audit and risk management), in which case the relevant committees should coordinate as appropriate.
- (c) The standing committees should report regularly to the full board. The board should adopt a schedule for the reports to be delivered by each committee, recognizing that it may be appropriate for some committees to report more frequently than others.

Section 6. Audit Committees and Board Oversight of Financial Reporting and Audit Functions

- (a) The board of the top-tier entity within a banking organization should have an audit committee, composed entirely of independent directors, with sole authority to appoint, terminate and approve compensation for independent auditors.
- (b) The members of the audit committee of the top-tier entity collectively should have appropriate accounting, banking and related financial expertise and experience, including at least one member who is an audit committee financial expert under SEC rules.
- (c) The audit committee, or another independent committee, should review and approve procedures for the receipt, retention and treatment of complaints regarding compliance issues, including confidential, anonymous submissions by employees or other parties of accounting or auditing concerns.

Section 7. Nominating/Corporate Governance Committees, Director Qualifications and Board Oversight of Director Nomination Process

- (a) The board of the top-tier entity within a banking organization should have a committee, composed entirely of independent directors, to conduct the director nomination process and assess the qualifications and independence of director candidates.
- (b) This committee should establish factors to be considered in evaluating prospective director nominees and in evaluating directors for

membership on board committees, taking into account the circumstances and businesses of the banking organization and the responsibilities of the various committees.

- (c) The board of the top-tier entity within a banking organization should have a committee, composed entirely of independent directors, with responsibility for corporate governance, including responsibility for the board self-evaluation process and advice and assistance to the board in overseeing the entity's corporate governance structures, processes and performance.
- (d) The nominating and corporate governance committee functions may be joined together, may be undertaken by separate independent committees or may be apportioned to independent committees that have other functions.

Section 8. Compensation Committees and Board Oversight of Executive Compensation

- (a) The board of the top-tier entity within a banking organization should have a compensation committee, composed entirely of independent directors, to approve the compensation of the CEO and to oversee the compensation of other senior executives and the development of compensation programs that attract and retain highly qualified executives and other employees, satisfy regulatory standards and discourage inappropriate risk taking.
- (b) The compensation committee should have an understanding of compensation practices in the financial services sector and should review and approve compensation practices that appropriately balance risk and reward (with input from the chief risk officer and the risk committee, as appropriate) and take into account compliance performance and ethical behavior.

Section 9. Risk Committees and Board Oversight of Risk Management

- (a) The board of the top-tier entity within a banking organization should have a committee to monitor its risk management systems and control procedures for identifying, assessing and managing its risk exposures.
- (b) This committee should include at least one member with substantial risk management knowledge and experience.

Section 10. Funding and Authority to Engage Advisors

The board and each committee of the board should have the authority to engage counsel and outside advisors as it deems necessary to carry out its duties, and should be able to call upon the banking organization for appropriate funding to compensate such counsel and advisors and to pay other administrative expenses.

Section 11. Independent Leadership of the Board

The board should determine its own form of independent leadership. If the board determines that the CEO or another non-independent director should serve as chairperson, the independent directors of the board should designate, among themselves, a lead independent director. The lead director should generally have authority to:

- (a) approve the agenda and schedule for each board meeting and the information to be provided to the board (board materials and board presentations); and
- (b) convene and chair regular and special executive sessions of the board (*i.e.*, sessions where no member of management, including the CEO, is present).

Section 12. Agenda, Materials and Length of Meetings

- (a) The agenda for each board and committee meeting should list the subjects that are expected to be discussed at the meeting.
- (b) Although board and committee meetings generally should follow the agenda, some flexibility may be necessary or appropriate to discuss matters that, because of the time at which they arose or for other reasons, are not listed on the agenda.
- (c) Materials for board and committee meetings (including the agenda) should be provided to directors sufficiently in advance of meetings, and should contain sufficient detail to enable the directors to prepare appropriately. It is recognized, however, that circumstances may necessitate shortening this time period on occasion. Directors are expected to have read board and committee materials that were provided in advance.
- (d) Board meetings should include presentations by senior management, other employees of the company and advisors, as appropriate, covering major business, financial performance, risk and control, and legal and compliance matters.

Committee meetings should include presentations tailored to the needs of the committee from time to time. Significant time should be reserved for board and committee discussions.

- (e) Directors should devote sufficient time in a meeting to address all agenda subjects and such other subjects as may be brought to their attention.

Section 13. Minutes of Board Meetings

- (a) The minutes of meetings of the board and its committees should be kept in accordance with the applicable corporate statute under which the banking organization is organized. The board should decide on the level of detail that it believes is appropriate for the minutes, balancing the need to maintain an adequate record to satisfy legal requirements and the need to avoid chilling discussion among directors. Although minutes may prove to be useful for bank regulator examiners reviewing corporate decision making, they are not designed for that purpose.
- (b) It is common practice not to create detailed minutes of executive sessions of independent directors, because doing so would be antithetical to the very objective of such sessions. The subject matter of such sessions and any formal actions taken may be noted in the minutes, as appropriate.

Section 14. Board Compensation

The board should adopt a compensation structure for the non-management directors, committee members and the individual directors with designated responsibilities (e.g., lead director and committee chairs) so that the most qualified individuals can be attracted and retained and the interests of directors and shareholders can be aligned, as appropriate.

Section 15. Meetings with Regulators

The board (or, as the board deems appropriate, specified directors) should seek to meet at least twice each year with the principal regulator(s) of the banking organization and, in any event, should inform each principal regulator that the board or specified directors are prepared to meet with the principal regulator, including in executive session, whenever the regulator requests.

Section 16. Director Elections, Shareholder Rights and Shareholder Engagement

Public bank holding companies should be appropriately responsive to shareholder interests in

protecting their voting franchise while recognizing a banking organization's special need for stability. The board, and in particular the independent directors, should remain apprised of and, as appropriate, help to guide and, as appropriate, participate with management in the organization's shareholder engagement approach and implementation. ■

# Commentary

# Commentary

## Section 1. Basic Responsibilities of the Board and Management

### **Principles:**

- (a) Under law, the business and affairs of a corporation, including a banking organization, are managed under the direction of a board of directors. The board delegates to a professional and full-time management team the day-to-day operation of the company. This positions the board to provide oversight of—and serve as an independent check on—management. Maintaining a distinction between the respective roles of the board and of management is necessary in any corporation, including banking organizations.**
- (b) The board is responsible for making certain statutorily identified decisions, for selecting the chief executive officer, and for providing oversight of the business and affairs of a banking organization and its management.**
- (c) Management is responsible for the day-to-day operations of the banking organization.**

### **Commentary:**

The role of directors of banking organizations is established by a matrix of federal banking statutes and regulations and pronouncements by bank regulators, as well as state statutes and common law.<sup>2</sup> The Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) has recognized that “[i]n the exercise of their duties, directors [of banking organizations] are governed by federal and state banking, securities, and antitrust statutes, as well as by common law . . . .”<sup>3</sup>

Under general and longstanding principles of corporate law, the fundamental obligations of the board of directors of a corporation are its fiduciary duties of care and loyalty owed to the entity and its shareholders. The specific obligations imposed on directors of banking organizations

by banking statutes, regulations and pronouncements are largely intended to protect the safety and soundness of banking organizations; these requirements should not be viewed as altering the directors’ traditional duties or creating “new” fiduciary duties, but rather should be viewed as providing specific directives that inform the manner in which the directors undertake their traditional duty of care. Recent suggestions that the directors of banking organizations should have fiduciary duties to persons other than just shareholders are beyond the scope of these Governance Principles. TCH believes, however, that such suggestions should be approached with caution because of the uncertainty and potential conflicts that such expansion of fiduciary duties could create and the potential discouragement of qualified individuals from serving on bank boards.

Although the ultimate responsibility for the affairs of the organization rests with the board, the formulation of strategic plans and day-to-day management of the organization is delegated to its officers, with the board exercising oversight. The line between oversight and management will not always be clear, and the manner of implementation of the board’s oversight will vary from institution to institution. Nevertheless, it is a well-established principle of corporate governance that the board of a corporate entity, including a banking organization, generally is responsible for supervising and monitoring the affairs of the organization, while the responsibility for the day-to-day conduct of the organization’s business resides with management. Indeed, the board should not embroil itself in so many details that it interferes with management prerogatives or is limited in performing its general oversight role. Moreover, for the directors to attempt to exercise active day-to-day management or control could create serious safety and soundness issues because the directors normally would lack the experience, expertise, time and knowledge to perform such a role, and could compromise the board’s independence, which is a hallmark of sound corporate governance.

This crucial distinction between the oversight responsibilities of the board and the day-to-day management of banking organizations by managers and employees has been recognized by federal bank regulators. The Federal Reserve Board has stated that the board of a member bank “should delegate the day-to-day routine of conducting the bank’s business to its officers and employees. . . .”<sup>4</sup> The Office of the Comptroller of the

2 See, e.g., 12 U.S.C. § 24 (conduct of business of national banks); 12 U.S.C. §§ 71-76 (management of affairs of national banks); 12 C.F.R. § 7.2010 (“The business and affairs of the bank shall be managed by or under the direction of the board of directors.”); 8 Del. C. § 141(a) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .”); N.Y. Bus. Corp. § 701 (“[T]he business of a corporation shall be managed under the direction of its board of directors . . . .”); N.Y. Banking § 7001 (“The affairs of every corporation shall be managed by a board of directors . . . .”).

3 See Division of Banking Supervision and Regulation, Federal Reserve Board, Commercial Bank Examination Manual (1995) (“Commercial Bank Manual”), Section 5000.1, at 1 (2013).

4 Commercial Bank Manual, Section 5000.1, at 1; see also Michael P. Malloy, Banking Law and Regulation, (2<sup>nd</sup> ed., 2013) (“Malloy-Banking Law”), Section 4.02[D], at 1 (“As a general rule . . . it is expected that much of the function of day-to-day management will be delegated to the executive officers . . .”).

Currency (“OCC”) also has stated that the role of national bank directors is to oversee the bank and that one of their most fundamental responsibilities is to select and retain competent management who have “the ability to manage day-to-day operations to achieve the bank’s performance goals.”<sup>5</sup> Similarly, the Federal Deposit Insurance Corporation (“FDIC”), in the Pocket Guide for Directors (“FDIC Pocket Guide”), has declared that the role of an insured banking organization’s board is to oversee the conduct of the institution’s business.

The separate roles of directors and officers have been recognized by bank regulators outside the United States as well. For instance, David Walker observed in his review of corporate governance in U.K. banks that “the core separation between the roles [of the board and management] is well-entrenched if not always well-understood.”<sup>6</sup> The Basel Committee on Banking Supervision (the “Basel Committee”), a committee consisting of senior representatives of bank supervisory authorities and the central banks of over 25 countries, adopted this precept as one of its foremost principles for sound corporate governance of banking organizations.<sup>7</sup> The Group of Thirty also emphasized the importance of this distinction in their April 2012 publication on the governance of financial institutions.<sup>8</sup>

Of course, the division of responsibilities between the board and management is not restricted to banking organizations and is generally applicable to corporate

entities.<sup>9</sup> As the ABA further explains, directors should provide leadership for the business organization through decision making and oversight.<sup>10</sup> In general, the board’s oversight function involves (i) reviewing and approving corporate policy and strategic goals, (ii) hiring, evaluating and compensating a chief executive officer and other senior executives, (iii) approving major expenditures, acquisitions and divestitures, (iv) evaluating the risk management structure and (v) monitoring financial performance, management performance and compliance with legal obligations and corporate policies.<sup>11</sup> For a further discussion of particular areas that should be included in the board’s oversight responsibilities, see Section 4 of these Governance Principles.

One key component of the board’s oversight role is to review and discuss overall strategy for the banking organization and to oversee the establishment of policies and procedures (including, importantly, those related to risk management) such that all significant activities of the banking organization are “covered by clearly communicated written policies that can be readily understood by all employees.”<sup>12</sup> The board should oversee management’s implementation of such strategies and policies and delegate responsibility for day-to-day business decisions to senior executives and other

5 OCC, *The Role of a National Bank Director: The Director’s Book* (reprint September 2013) (October 2010) (“OCC Director’s Book”), at 21.

6 David Walker, *A Review of Corporate Governance in U.K. Banks and Other Financial Industry Entities: Final Recommendations* (2009) (“Walker Review”), at 35.

7 See Basel Committee, *Principles for Enhancing Corporate Governance* (October 2010) (the “Basel Principles”), at 7 (“The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank’s strategic objectives, risk strategy, corporate governance and corporate values. The board also is responsible for providing oversight of senior management.”); see also Organization for Economic Co-Operation and Development, *Principles of Corporate Governance* (2004) (“OECD Principles”), at 58 (“Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance . . .”).

8 See Group of Thirty, *Toward Effective Governance of Financial Institutions* (2012) (“G30 Report”), at 40 (“[I]t is essential that the board remain independent and allow management to execute the day-to-day activities of the organization”); *id.* at 42 (“[B]oards may make a critical mistake if they permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk governance, and talent issues”); *id.* at 66 (“It is one thing to support and encourage an active and engaged board that is properly familiar with the risks being taken by the organization; it is another to drive boards to an excessive focus on detailed operational matters that are more properly the purview of management.”).

9 See, e.g., *Schoonejongen v. Curtiss-Wright Corp.*, 143 F.3d 120, 127 (3rd Cir. 1998) (“[T]he ability to delegate is the essence of corporate management, as the law does not expect the board to fully immerse itself in the daily complexities of corporate operation.”); *Grimes v. Donald*, 1995 WL 54441, at \*8 (Del. Ch. Jan. 11, 1995), *aff’d*, 673 A.2d 1207 (Del. 1996) (noting that Delaware law expressly permits the board to “delegate managerial duties to officers of the corporation”); *Cahall v. Lofland*, 114 A. 224, 229 (Del. Ch. 1921), *aff’d*, 118 A. 1 (Del. Ch. 1922) (“The duties of directors are administrative, and relate to supervision, direction and control, the details of the business being delegated to inferior officers, agents and employees. This is what is meant by management.”); The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, § 3.01, Cmt. a, at 80 (1994) (“[I]t is generally recognized that the board of directors is not expected to operate the business. Even under statutes providing that the business and affairs shall be ‘managed’ by the board of directors, it is recognized that actual operation is a function of management. The responsibility of the board is limited to overseeing such operation.” (citation omitted)); Committee on Corporate Laws, American Bar Association (“ABA”) Section of Business Law, *Corporate Director’s Guidebook* (6th ed., 2011) (“ABA Guidebook”), at 11 (“Although the board is responsible for managing and overseeing corporate affairs, it typically delegates responsibility for day-to-day operations to a team of professional [m]anagers”); OECD Principles, at 58 (“Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance . . .”). The guidance in the ABA Guidebook that is referenced throughout these Governance Principles is not tailored to banking entities specifically, but rather applies to all public companies (and, to some extent, to corporations generally). See ABA Guidebook, Foreword (“The Guidebook provides important information for directors of public companies, but it is also relevant to directors of all companies . . .”).

10 ABA Guidebook, at 11-12.

11 *Id.* at 13.

12 FDIC Pocket Guide.

employees.<sup>13</sup> Good corporate governance requires that the board and management have a clear understanding of their respective roles and obligations. A clear and well understood separation of roles between the board and management not only enhances corporate governance but also contributes to the efficient operation of the organization.

TCH recognizes that the board's oversight role includes what has become termed by the bank regulators as "challenge" to management. We believe that challenge should consist primarily of informed and probing questions of management, at or outside of board meetings, rather than a formal record of disagreements with management or rejections of management recommendations. In particular, we do not believe that the effectiveness of challenge can be evaluated based on the number of challenges recorded in the minutes or elsewhere.

In the wake of the financial crisis of 2008, Congress and federal bank regulators have often asserted an expanded role for the boards of banking organizations. This trend is exemplified by certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010<sup>14</sup> (the "Dodd-Frank Act") and accompanying regulations. For example, as discussed further in Section 8 of these Governance Principles, pursuant to the rules proposed by federal bank regulators under Section 956 of the Dodd-Frank Act, the board or the compensation committee of a banking organization that has consolidated assets of \$1 billion or more will be required to approve policies and procedures regarding compensation arrangements that effectively balance the financial rewards to employees with the risks associated with their activities and reduce incentives for inappropriate risk taking. In addition, as discussed further in Section 4 of these Governance Principles, under the "living will" requirements of Section 165(d) of the Dodd-Frank Act, boards of bank holding companies with total consolidated assets of \$50 billion or more are required to approve plans for "rapid and orderly resolution in the event of material financial distress or failure" under the U.S. Bankruptcy Code in a way that would not pose systemic risk to the financial system. Furthermore, the Federal Reserve Board recently finalized rules to implement the enhanced prudential standards mandated by Section 165 of the Dodd-Frank Act, including

requirements for board oversight, and certain of these final rules establish requirements for boards.<sup>15</sup>

Enforcement actions by bank regulators also have imposed expanded responsibilities on the boards of particular banking organizations in specific contexts. For example, consent orders entered into between federal bank regulators and numerous banking organizations regarding their mortgage servicing operations require the banking organization's board to "ensure that . . . the Bank achieves and maintains effective mortgage servicing, foreclosure, and loss mitigation activities . . . , as well as associated risk management, compliance, quality control, audit, training, staffing, and related functions."<sup>16</sup>

TCH believes that, although the exact delineation between the roles of the board and management depends on a banking organization's particular situation, any significant involvement by the board in day-to-day operations is likely to reduce the board's ability to perform its general oversight role most effectively. Moreover, TCH recognizes that the time commitment of directors will depend on the banking organization's circumstances but cautions that, absent extenuating, temporary circumstances, requiring abnormal time commitments of directors could impede an organization's ability to attract qualified candidates for board positions. In addition, a board should be highly reluctant to take on additional duties unless the board is convinced that it has the necessary expertise and time to perform those duties appropriately and that doing so will not result in confusion as to decision-making authority. Of course, certain unusual circumstances may require an enhanced level of oversight by the board (though this does not mean that the board is acting in the role of management). For example, when a banking organization is subject to an enforcement action by the regulators, directors of the organization may be obligated to oversee in a more active manner the timely implementation of corrective actions and assess the banking organization's compliance.<sup>17</sup> It is critical, however, that the specific requirements with respect to corrective actions in this

13 See Basel Principles, at 2 ("Under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board."); FDIC, Statement Concerning the Responsibilities of Bank Directors and Officers (last updated September 16, 2013) ("Officers are responsible for running the day-to-day operations of the institution in compliance with applicable laws, rules, regulations and the principles of safety and soundness.").

14 Pub. L. No. 111-203, 124 Stat. 1426.

15 See Sections 4 and 9 for a further discussion of these final rules. See also OCC, Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations and Insured Federal Branches; Integration of Regulations (September 2, 2014) (the "OCC Guidelines") (requiring an increased responsibility for the boards of directors of certain large national banks).

16 OCC, Consent Orders with National Bank Mortgage Servicers (April 13, 2011, amended February 28, 2013) (collectively, the "OCC Consent Orders"), Article III, Section 2; Federal Reserve Board, Consent Orders Related to Residential Mortgage Loan Servicing and Foreclosure Processing (April 13, 2011, amended February 28, 2013) (collectively, the "Federal Reserve Consent Orders") (requiring bank holding company boards to submit written plans to strengthen their oversight of enterprise-wide risk management, internal audit, and compliance programs concerning the residential mortgage loan servicing, loss mitigation, and foreclosure activities conducted through their subsidiary banks).

17 See OCC Director's Book, at 95.

context should not be permitted to distract the board from its broader oversight functions.<sup>18</sup>

The board also may, as a practical matter, become more active as an organization experiences financial difficulty. For instance, directors of an insolvent Delaware corporation may determine to participate more actively in key corporate decisions to the extent necessary to protect the interest of creditors. Furthermore, under Delaware law, the actions of directors reacting to a threatened change in control may be subject to enhanced judicial scrutiny, and the level of involvement of directors in decision making should be considered in that light.<sup>19</sup> Moreover, when directors are deciding to sell the company, they are charged with the duty to seek the best price for the shareholders.<sup>20</sup> In these circumstances, the board will often determine to be more closely involved in making key decisions and, in certain circumstances, to consider relying on its own legal and financial advisors in addition to management.

The foregoing situations may lead to enhanced involvement by the board on a temporary basis, but the board is nevertheless still acting in an oversight role. There may be truly exceptional circumstances where the board's role may go beyond oversight. For example, in the event of a sudden departure or incapacitation of one or more senior executives, it may be necessary and appropriate for a director selected by the board to assume a lead management role on a temporary basis pending the appointment of succeeding senior executives. This level of involvement, however, is not a normal function of the board.

## Section 2. Independence of Board Members

### **Principles:**

#### **(a) A substantial majority of the directors of the top-tier entity within a banking organization should be independent, and only a relatively**

#### **small number of directors should be members of management.**

#### **(b) The board of the holding company should review the composition, including the independence requirements, of the boards of its subsidiary banks.**

### **Commentary:**

"Independence" for these purposes means that a director of a banking organization does not have other direct or indirect relationships with the organization that could impede the director's exercise of independent judgment in executing the duties of a director. Directors who are executives of the organization (*i.e.*, "management" directors) clearly are not independent, and, as discussed below, there should in practice be a limit on the number of management directors separate and apart from the limit on the number of total non-independent directors.

In addition to independence requirements and recommendations, discussed below, that apply generally to public companies, federal bank regulators encourage banks to establish and maintain the independence of the board by including an appropriate number of independent directors on their boards. For instance, the recently finalized OCC Guidelines require certain large national banks to have at least two "independent" directors on their boards.<sup>21</sup> In the OCC Director's Book, the OCC stresses the importance of independent directors on national bank boards who can provide "perspective and objectivity" in overseeing bank operations and evaluating management recommendations.<sup>22</sup> According to the OCC Director's Book, a director generally can be deemed independent if he or she is "a non-management director free of any family relationship or any material business or professional relationship (other than stock ownership and the directorship itself) with the bank or its management."<sup>23</sup>

Regulators and commentators disagree as to whether significant stock ownership, or affiliation with a significant

18 This point was addressed by Federal Reserve Governor Daniel Tarullo in a June 9, 2014 speech, in which he notes that it has "perhaps become a little too reflexive a reaction on the part of regulators to jump from the observation that a regulation is important to the conclusion that the board must certify compliance through its own processes" and that regulators "should probably be somewhat more selective in creating the regulatory checklist for board compliance and regular consideration." Governor Tarullo noted as an example the Federal Reserve's supervisory guidance regarding board review of "Matters Requiring Attention" (MRAs), noting that "[t]here are some MRAs that clearly should come to the board's attention, but the failure to discriminate among them is almost surely distracting from strategic and risk-related analyses and oversight by boards." Speech by Governor Daniel K. Tarullo at the Association of American Law Schools 2014 Midyear Meeting, Washington, D.C. (June 9, 2014).

19 See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

20 See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

21 A director is "independent" for these purposes if the director (i) is not an officer or employee, and has not been an officer or employee within the last three years, of the parent company or the bank, (ii) is not a member of the immediate family of a person who is, or has been within the last three years, an executive officer of the parent company or the bank and (iii) qualifies as an independent director under the listing standards of a national securities exchange, as demonstrated to the satisfaction of the OCC. See OCC Guidelines, at 76 & 127. The OCC further noted that, if the bank's independent directors are also members of the parent company's board, the OCC expects that such directors would consider the safety and soundness of the bank in decisions made by the parent company that impact the bank's risk profile. *Id.* at 76.

22 OCC Director's Book, at 3.

23 *Id.* at 3 n.2; see also FDIC Pocket Guide (stating that banking institutions should establish and maintain the independence of the board); Basel Principles, at 10-11 ("Independence can be enhanced by including a large enough number of qualified non-executive members on the board who are capable of exercising sound objective judgment.").

stockholder, should be seen as impairing a director's independence. On the one hand, the New York Stock Exchange ("NYSE") and NASDAQ listing standards expressly state that stock ownership does not, by itself, impair independence, because the key consideration is independence *from management*.<sup>24</sup> Similarly, the OCC carves out "stock ownership" from the factors compelling a non-independence determination.<sup>25</sup> In contrast, the Federal Reserve Board notes that it is important for the board of a bank to include "directors with no ownership or family ownership interest in the bank and who are not employed by the bank."<sup>26</sup> TCH believes that ownership of a significant stock position, or affiliation with such an owner, should not be a bar to independence of a director of a banking organization. In most cases, the interests of a shareholder and the public interests that a director is meant to protect—including the safety and soundness of the organization—will be aligned. In those circumstances where a particular shareholder may have divergent interests from the other shareholders or the organization (for example, if he or she owns a controlling interest in the organization), the other independent directors should assess whether a director who is, or is affiliated with, the shareholder can continue to exercise independent judgment. If a director cannot exercise independent judgment on a particular matter, he or she should be recused from voting on, and, if appropriate, recused from the deliberations on, the matter.

#### Independence of Holding Company Board

Bank holding companies with securities listed on national securities exchanges are subject to the director independence rules of those exchanges. These rules require a company with securities listed on these exchanges to have a majority of independent directors on its board.<sup>27</sup> According to the NYSE, the independence rule is designed to "increase the quality of board oversight and lessen the possibility of damaging conflicts of interest."<sup>28</sup>

TCH believes that, as a matter of good corporate governance, a *substantial* majority (*i.e.*, at least two-thirds) of directors of the top-tier entity within a banking organization should be independent, with independence to be defined pursuant to applicable stock exchange standards and an independence policy adopted by the board (as described further below). Although this standard is in excess of any securities exchange or other explicit regulatory requirements, TCH believes that a board with only a slight majority of independent directors risks being

dominated by the non-independent directors, particularly if they are members of management and closer to the day-to-day business of the organization.<sup>29</sup>

For similar reasons, TCH believes that only a relatively small number of directors should be members of management; specifically, management directors should not comprise more than 25% of the board. Although a management presence on the board provides an indispensable connection between the board and management and the board may determine to have more than one management director in order to have consistent access to a variety of management views, TCH believes that having more than 25% management members on a holding company board may tend to restrict the independence of the board overall. As David Walker noted in his review of U.K. banking organizations, "the stronger the executive presence in any board . . . the greater the risk that overall board decisions come to be unduly influenced by what has been described as 'executive groupthink.'"<sup>30</sup> In special circumstances, the board of a particular organization may decide that, for reasons specific to the organization, this limitation on management directors is not appropriate.

The NYSE provides that a director is not "independent" unless the board of a listed company makes an affirmative determination that there is no material relationship (including commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others) between the director (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company) and the listed company.<sup>31</sup> The NYSE advises the board to consider "all relevant facts and circumstances" in reaching its determination as to a director's independence, including the director's personal relationships with the listed company as well as the relationships, if any, between the listed company and "persons or organizations with which the director has an affiliation."<sup>32</sup> TCH believes that banking organizations should adopt a formal policy, setting forth categories of relationships that generally will be deemed material or immaterial for these purposes, in order to assist the board in making independence determinations in a consistent and reasoned manner.

Although the NYSE grants discretion to the board in reaching independence determinations based on the director's relationships with the company, it also sets

24 See NYSE, Listed Company Manual ("NYSE Manual"), Section 303A.02(a) (commentary); NASDAQ, Listing Rules ("NASDAQ Rules"), IM-5605.

25 OCC Director's Book, at 3 n.2.

26 See Commercial Bank Manual, Section 5000.1, at 1.

27 NYSE Manual, Section 303A.01; NASDAQ Rules, Section 5605(b)(1).

28 NYSE Manual, Section 303A.01.

29 See, e.g., U.S. General Accounting Office, Report to Congressional Requesters, GAO-04-75, Securities Markets: Opportunities Exist to Enhance Investor Confidence and Improve Listing Program Oversight (2004) ("GAO Report"), at 73-74.

30 Walker Review, at 42; see also N.Y. Banking Law § 7001 (2014) (requiring that no more than one-third of the directors of a New York state chartered bank be active officers or employees of the bank).

31 NYSE Manual, Section 303A.02(a).

32 *Id.*

certain minimum standards that must be met before a director can be deemed independent. The NYSE has identified the following types of relationships as presumptively inconsistent with a director's independence:

- (i) the director is, or was, an employee of the listed company, or an immediate family member is, or was, an executive officer, of the listed company, within the last three years;
- (ii) the director or an immediate family member received more than \$120,000 per year in direct compensation from the listed company within the last three years, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);
- (iii) (A) the director currently is affiliated with or employed by a firm that is the internal or external auditor of the listed company, (B) the director or an immediate family member was affiliated with or employed by such firm within the last three years and personally worked on the listed company's audit within that time, (C) an immediate family member currently is affiliated with such firm or (D) an immediate family member currently is employed by such firm and personally works on the listed company's audit;
- (iv) the director or an immediate family member is, or was employed as, an executive officer of another company where any of the listed company's present executives serves or served on that company's compensation committee within the last three years; or
- (v) the director is a current employee, or an immediate family member is a current executive officer, of another company that, within the last three years, has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million and 2% of such other company's consolidated gross revenues.<sup>33</sup>

For these purposes, "immediate family member" includes "a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home."<sup>34</sup> The term "executive officer" is defined by reference to the definition in Securities Exchange Act of 1934<sup>35</sup> (the "Exchange Act") Rule 16a-1(f), as follows:

33 NYSE Manual, Section 303A.02(b).

34 *Id.*

35 15 U.S.C. § 78a *et seq.*

[A]n issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer. Officers of the issuer's parent(s) or subsidiaries shall be deemed officers of the issuer if they perform such policy making functions for the issuer.<sup>36</sup>

This definition generally is consistent with that used for proxy disclosure purposes<sup>37</sup> and under Regulation O, 12 C.F.R. § 215.2(e). The independence standards of other national securities exchanges generally are similar to those of the NYSE.<sup>38</sup>

Federal bank regulators, the SEC and the national securities exchanges also have adopted regulations requiring the independence of directors serving on the board's audit, risk, compensation and nominating/corporate governance committees.<sup>39</sup> These independence requirements are discussed in detail in Section 5 through Section 9 of these Governance Principles.

Finally, the Depository Institution Management Interlocks Act<sup>40</sup> prohibits director and officer interlocks among depository organizations, with certain exceptions. Directors at both the holding company level and the bank level should not have other positions that could cause them to be a "management official" of another depository organization, absent an applicable exception. Similarly, banking organizations should monitor the application of antitrust provisions that may prohibit individuals from serving as directors or officers of two competing corporations.<sup>41</sup>

#### Independence and Composition of Subsidiary Bank Board

Federal bank regulators have not adopted specific independence requirements for boards of banks, although, as discussed above, the regulators generally have cited the importance of independent directors and the OCC recently has finalized guidelines requiring certain large national banks to have at least two independent directors

36 Exchange Act Rule 16a-1(f); *see also* NYSE Manual, Section 303A.02.

37 *See* Exchange Act Rule 3b-7.

38 *See* NASDAQ Rules, Section 5605(a)(2).

39 *See* 12 C.F.R. § 363.5(a)(2); OCC Director's Book, at 29; Federal Reserve Enhanced Standards, §§ 252.22(d) & 252.33(a)(4); Exchange Act Rule 10A-3(b)(3)(ii); NYSE Manual, Sections 303A.04, 303A.05 & 303A.06; NASDAQ Rules, Sections 5605(c)(2)(A), 5605(d)(2)(A) and 5605(e)(1)(B).

40 As implemented by Regulation L, 12 C.F.R. § 212.

41 *See* Clayton Antitrust Act of 1914, Pub. L. No. 63-212, 38 Stat. 730 § 8.

on their boards.<sup>42</sup> TCH believes that, with regard to the composition of the boards of subsidiary banks, banking organizations should have significant flexibility. The board of the holding company should review the composition, including the independence requirements and the definition of independence for these purposes, of the boards of its subsidiary banks. This decision may turn on a variety of factors, and a holding company with multiple bank subsidiaries may decide that different models of board composition are appropriate for the boards of those subsidiary banks. Some appropriate models for the composition of subsidiary bank boards include the following:

- (i) *The board of the subsidiary bank has little or no overlap with the holding company board, and includes some independent directors.* This may be more appropriate where the bank is one of a number of businesses within the holding company structure. In this case, separate oversight at the bank level, including some independent directors, can help serve as an additional check on business or strategy decisions relating to the operation of the bank that may make sense for the holding company as a whole, but risk undermining the safety and soundness of the bank as an entity.
- (ii) *The boards of the holding company and the subsidiary bank largely or completely overlap.* This may be especially appropriate if the lead bank comprises the predominant portion of the holding company's operations, due to the high degree of alignment between the interests of the bank and the interests of the holding company. As a general matter, there is no reason why an independent director serving on the holding company board would not also be viewed as independent when serving on the bank board as well. Of course, directors who serve on both holding company and subsidiary bank boards should remain cognizant of the role in which they are acting at any particular time, and their responsibilities to the entity of which they are acting as a board member.
- (iii) *The board of the subsidiary bank is composed predominantly or entirely of management directors with knowledge and expertise as to the bank's operations.* A holding company board may reasonably conclude that the bank's operations are an integral part of the holding company and that the oversight by the independent holding company board will be an effective check on excessive management control, while management directors are in the best position

<sup>42</sup> See OCC Guidelines, at 76 & 127. The OCC further noted that, if the bank's independent directors are also members of the parent company's board, the OCC expects that such directors would consider the safety and soundness of the bank in decisions made by the parent company that impact the bank's risk profile. *Id.* at 76. In addition, as discussed in Sections 5 and 6 below, federal bank regulations require certain banks to have audit committees that satisfy specified independence criteria. See 12 C.F.R. § 363.5(a)(2).

to oversee the bank. Often such an inside board includes representatives of the holding company's control functions charged with implementing the organization's overall policies and compliance with applicable laws and regulations. Of course, any such structure would need to comply with any relevant requirements for independent board members.<sup>43</sup>

- (iv) *The board of the subsidiary bank emphasizes representation of local constituencies.* This model may be particularly useful for multi-bank holding companies spread over a large geographic area. In such cases, the holding company board may reasonably determine that it will oversee the entity-wide risk oversight function, while the local bank board will be in a better position to provide input helpful to fostering optimal service to the local community and, in overseeing risk management at the bank, to identify any concerns with the application of the organization's risk oversight practices to the particular bank.

Using these or other models, banking organizations should review the composition of boards of subsidiary banks based on the particular circumstances and needs of those banks and the organization as a whole. This approach also is consistent with the rules of the national securities exchanges which generally exempt "controlled companies"—*i.e.*, wholly or majority owned subsidiaries—from their independence rules.<sup>44</sup> TCH believes that it is desirable for both the top-tier entity board, as the governing body of the controlling shareholder of the subsidiary bank, and the subsidiary bank board to review periodically the subsidiary bank's board structure.

### Section 3. Size of the Board

#### **Principles:**

- (a) The board of the top-tier entity within the banking organization should have the flexibility to determine its own appropriate size and the board size for its subsidiary banks, within any statutory requirements.**
- (b) The board should be small enough to facilitate effective functioning but large enough to allow members to contribute sufficient knowledge, experience and diversity to the board's oversight role and its committees.**
- (c) Decisions on board size will depend on a banking organization's particular circumstances, needs and objectives, including:**

<sup>43</sup> See, *e.g.*, OCC Guidelines, at 76 & 127 (requiring two independent directors at large national banks).

<sup>44</sup> See NYSE Manual, Section 303A.00 and NASDAQ Rules, Section 5615(c).

- (i) **the nature, scope and complexity of its business;**
- (ii) **the need to meet applicable independence and other regulatory standards;**
- (iii) **the need to provide a range of skills commensurate with the board’s oversight role and a diversity of views that can provide necessary insight into the banking organization’s multiple constituencies; and**
- (iv) **the ability to staff board committees with a sufficient number of members that meet relevant independence and qualification criteria and the needs of the committees.**

**Commentary:**

There is no “one-size-fits-all” approach to determining board size and there can be no general prescription regarding optimal board size for all banking organizations. Each banking organization has to evaluate its own circumstances and needs in determining the appropriate board size to meet its oversight objectives. The composition of the board of a bank holding company must, of course, comply with the general corporate laws of the state in which that company is incorporated, though these are typically not very prescriptive. Delaware law, for example, requires only a minimum of one director.<sup>45</sup> Holding companies with stock listed on an exchange should have a board size that enables compliance with applicable stock exchange rules, including having enough independent directors to maintain the required committees. Board committees and independence requirements for these committees are discussed in detail in Section 5 through Section 9 of these Governance Principles. Board size at the subsidiary bank level is the subject of more specific regulation and guidance, though significant flexibility still exists, as discussed further below.

The ideal number of directors to serve on a board is the subject of considerable debate. Literature on corporate governance contains various qualitative and quantitative guidance, although there is no agreement on any specific “ideal” size. The Basel Committee, for instance, broadly recommends that a board “structure itself in a way, including in terms of size . . . so as to promote efficiency, sufficiently deep review of matters, and robust critical challenge and discussion of issues.”<sup>46</sup> The ABA notes the substantial variation in the size of boards of public companies, but states that “[e]xcept perhaps for the very largest and most complex corporations, smaller boards (seven to eleven members) generally function more

effectively than larger ones.”<sup>47</sup> The ABA’s position is based on the view that smaller boards can allow directors more opportunities to participate actively in board deliberation, whereas larger boards can limit such participation. Large boards use their authority to delegate significant activities to committees of the board as a way of addressing this participation issue. Delegation of specific duties to committees also allows a subset of the board to delve more deeply into particular matters on behalf of the entire board.<sup>48</sup>

Moreover, there is recognition that banking organizations may require somewhat larger boards than other companies. The ABA notes that financial services corporations and corporations operating complex businesses typically have larger boards (as many as 15 or more members).<sup>49</sup> These commentaries support the general principle that decisions on board size should be commensurate with the nature and complexity of a banking organization’s business. Larger boards can also help support director diversity, in all its forms. See Section 7 of these Governance Principles for a further discussion of the growing emphasis on the importance of board diversity.

It is the view of TCH that, although the appropriate size of the board of the top-tier entity within a U.S. banking organization depends on what would be most efficient for that organization’s oversight objectives, a board size of less than 8 or more than 18 would seem undesirable, absent unusual circumstances. For example, one of the unusual circumstances that could result in a larger number of directors would be a merger, where substantial representation from both constituent organizations could assist in the oversight of the integration process. Whether

47 ABA Guidebook, at 42; see also G30 Report, at 34-35 (“[T]he bigger a board gets, the more difficult it is to manage. Meetings can get out of control or become so structured that it is difficult to have effective debate. Ultimately, the right size of the board depends on those seated around the table and how they interact, but on balance, smaller boards that require a greater time commitment from their members are better than larger boards that require a more modest commitment.”).

48 See *id.* at 42-43; see also Walker Review, at 41 (“Discussion and consultation in the course of the present [r]eview points to a widely held view that the overall effectiveness of the board, outside a quite narrow range, tends to vary inversely with its size. That view would probably tend to converge around an ‘ideal’ size of 10-12 members, not least on the basis that a larger board is less manageable, however talented the chairman, and that larger size inevitably inhibits the ability of individual directors to contribute.”) (citation omitted); John L. Colley, Jr. *et al.*, *Corporate Governance*, at 37 (2003) (“Colley-Governance”), at 37 (“There is a semblance of a consensus that some number between 12 and 15 is most effective for many organizations. Many people feel that fewer than 12 directors can allow a small group to control the board, whereas more than 15 directors renders the board unwieldy.”).

49 ABA Guidebook, at 42; see also Walker Review, at 41 (citing research by Deloitte showing U.K. listed banks as having much bigger boards and that the median bank board size has increased from 15 members in 2002/03 to 16 members in 2007/08, whereas the average board size across the whole of the FTSE 100 decreased from 11 to 10 members over the same period).

45 8 Del. C. § 141(b).

46 See Basel Principles, at 11.

the board size should be increased or decreased should be a subject of discussion in the board's self-evaluation process discussed in Section 7 of these Governance Principles.

At the subsidiary bank level, federal banking laws provide considerable flexibility to set board size within a numerical range. For example, in prescribing the required number of board members for national banks, the National Bank Act sets a range of not less than 5 nor more than 25 members, but the OCC's regulations authorize a national bank to request to expand its board even above the 25 member limit.<sup>50</sup> State member banks also are subject to a 5 to 25 member range for board size.<sup>51</sup> Different states also may have requirements on board size at the bank level. For example, the New York State Banking Law generally requires New York state chartered banks to have no less than 5 nor more than 15 board members, but allows larger banks to choose from a wider range for board size.<sup>52</sup>

TCH believes that the board of the top-tier entity of a banking organization should have considerable flexibility regarding the size of the boards of its subsidiary banks, depending on the complexity of the subsidiary banks, their roles within the larger organization and the extent to which the holding company board performs certain of the oversight functions with respect to the banks.<sup>53</sup>

#### Section 4. Oversight Duties of the Board

##### **Principles:**

- (a) **The oversight duties and responsibilities of the board of a banking organization should include the following:**
- (i) **reviewing financial performance, capital adequacy and liquidity on a regular basis;**
  - (ii) **reviewing and approving the organization's strategic objectives and plans on a regular basis;**
  - (iii) **monitoring management performance in formulating and implementing the organization's strategic plans and overseeing key business policies and procedures established by management;**
  - (iv) **setting the ethical "tone at the top" by overseeing the development and implementation of a code or codes of conduct applicable to directors and employees and**

50 12 U.S.C. § 71a; 12 C.F.R. § 7.2024(c); see also OCC Director's Book, at 3.

51 See 12 U.S.C. § 71a; Commercial Bank Manual, Section 5000.1, at 1.

52 N.Y. Banking Law § 7002 (2014).

53 See Section 2 of these Governance Principles for further discussion of the composition of subsidiary boards.

**that addresses treatment of breaches or lapses in ethical behavior, and approving appropriate corporate governance principles and other policies and procedures that position the board to fulfill its duties effectively and efficiently;**

- (v) **selecting and evaluating the performance and compensation of the Chief Executive Officer ("CEO") and such other senior executive officers as the board deems appropriate;**
  - (vi) **approving a management succession plan for the CEO and reviewing or approving management succession plans for other senior executive officers;**
  - (vii) **promoting a culture of compliance with applicable laws and regulations, and overseeing management's establishment, implementation and operation of a compliance system, including internal and external audit processes, disclosure controls and procedures, and responses to compliance failures;**
  - (viii) **understanding the organization's risk profile, reviewing the standards for the nature and level of risk the organization is willing to assume in light of the organization's capital and liquidity levels, approving capital plans and resolution plans, reviewing the organization's principal risk management policies and monitoring compliance with the foregoing (including having board meetings at least annually with discussions focused on these issues);**
  - (ix) **reviewing the organization's efforts to meet its community's credit needs, as appropriate;**
  - (x) **reviewing and approving related party transactions; and**
  - (xi) **performing all other oversight duties and responsibilities required by statute, regulation or regulatory orders (including oversight of executive compensation programs, liquidity and stress testing) or that the board deems appropriate from time to time.**
- (b) **The board may discharge these duties directly or through board committees to the extent permitted by applicable law.**
- (c) **For subsidiary banks, many of these responsibilities may be discharged by the board of the top-tier entity within the banking**

**organization, depending on the structure of the organization and the judgment of the top-tier board and the subsidiary bank board as to the appropriate allocation of responsibilities (subject in any case to specific regulatory requirements at the subsidiary bank level).**

**Commentary:**

As discussed in Section 1 of these Governance Principles, the key role of the board of a banking organization is to oversee the business and affairs of the organization. Federal bank regulators, courts and commentators have provided extensive guidance and direction as to the nature of the oversight duties and responsibilities of a banking organization's board, both at the holding company level and at the bank level. Therefore, these Governance Principles are not presented as an exhaustive list of all oversight duties and responsibilities but rather to illustrate core elements of such duties and responsibilities. In addition to the general duties discussed in these Governance Principles, various federal and state banking statutes and regulations impose specific responsibilities on the boards of banking organizations.

In this section, as elsewhere, these Governance Principles address the role of the board generally, both at the holding company level and at the bank level. As discussed in Section 2 with respect to director independence, the interaction between the holding company board and the bank board will vary significantly from organization to organization, and thus the specific level at which oversight of a particular area occurs also will vary. The responsibilities of the holding company board relate to the banking organization as a whole, and thus cover the operations of the subsidiary banks and other subsidiaries. Although the OCC confirms that a "holding company's directors may oversee and review the role and responsibilities of a subsidiary bank's board of directors," the OCC emphasizes that "the primary duty of the subsidiary bank's board of directors is to protect the bank."<sup>54</sup> In addition, the OCC Guidelines maintain that the subsidiary bank's risk governance framework should "ensure that... the safety and soundness of the [bank] is not jeopardized by decisions made by the parent company's board of directors and management."<sup>55</sup> TCH believes that, subject to specific regulatory requirements at the bank level, a banking organization should generally have flexibility in coordinating oversight responsibilities between the bank board and the holding company board. However, any allocation of responsibilities to the holding company board must be consistent with the discharge

by the subsidiary bank board of its critical responsibility to protect the safety and soundness of the bank – the bank should never simply function as a booking entity for the holding company, and neither the subsidiary bank board nor the holding company board should allow the safety and soundness of the bank to be undermined by strategic or business objectives that may make sense for the organization more broadly, but are prejudicial to the interests of the bank.

*Strategic Objectives.* TCH believes that the board should review, discuss and approve overall strategic objectives on a regular schedule, as it deems appropriate. The board's role in approving the overall strategic objectives and plans of the banking organization, as formulated by management, is a reflection of the fact that it is ultimately responsible for the affairs of the organization.<sup>56</sup> According to the Federal Reserve Board, the director's role is to provide a clear set of overall objectives within which senior executives can administer the bank's day-to-day operations.<sup>57</sup> As the Federal Reserve Board explains, the strategic objectives approved by the board should discuss "long-term, and in some cases, short-term goals and objectives as well as how progress toward their achievement will be measured" and that such objectives should "cover all areas of the bank's operations."<sup>58</sup> The board's understanding and approval of the organization's overall strategic objectives and plans place the directors in a stronger position to consider and, as necessary, challenge management's plans and evaluate management's performance in implementing that strategy.

The form in which a company's strategic objectives are expressed and documented will necessarily vary for each organization, as will the nature of the board's review and approval of those objectives. For some companies, the strategy may take the form of a clearly defined strategy document reflecting proposed steps, time lines and quantified targets and objectives. In many cases, however, particularly for complex organizations, the board's engagement with the banking organization's strategic objectives will take place in the context of broad discussions by the board and management as to short- and long-term objectives for various business lines,

54 OCC Director's Book, at 26; see also *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 906 A.2d 168, 201 (Del. Ch. 2006) (holding that, absent specific legal obligations, directors of wholly owned subsidiaries can follow and support the business judgment and strategies of the parent).

55 See OCC Guidelines, at 12 & 108.

56 See, e.g., 12 U.S.C. §§ 71-76 (describing management of the affairs of national banks); 12 C.F.R. § 7.2010 ("The business and affairs of the bank shall be managed by or under the direction of the board of directors."); 8 Del. C. § 141 ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."); see also discussion *supra* in Section 1.

57 See Commercial Bank Manual, Section 5000.1, at 2; see also *Grimes v. Donald*, 673 A.2d 1207, 1214 (Del. 1996) (discussing the board's duty to make informed decisions regarding matters at the "heart of the management of the corporation"); *Abercrombie v. Davies*, 123 A.2d 893, 899 (Del. Ch. 1956) (same); ABA Guidebook, at 11 (describing the board's responsibility for approving corporate policy and strategic goals).

58 See Commercial Bank Manual, Section 5000.1, at 2.

the outlook for regulatory and compliance functions, management succession planning, challenges to be met or other similar matters. Regardless of the manner in which the company's strategic objectives are documented or presented, they should provide the board and management with a framework for monitoring ongoing progress as to their implementation. Depending on the form of documentation and presentation of the company's strategic objectives to the board, the board's approval of those objectives may take the form of a formal vote concerning a defined strategy document, a consensus discussion or any other method permitting use of the strategic objectives as a framework consistent with the foregoing.

*Monitoring Management Performance.* Although the board may delegate the responsibility of running the banking organization's daily operations, it ultimately retains responsibility for monitoring the performance of the organization and its management in light of the strategic objectives outlined by the board. The Basel Committee recommends that the board monitor the actions of management by meeting regularly with senior management and by critically questioning and reviewing "explanations and information provided by senior management."<sup>59</sup> In carrying out its monitoring function, the board may rely on summaries and reports prepared by management to the extent the board believes reasonably and in good faith that they are reliable.<sup>60</sup> The OCC states that the board "must do more than merely accept and review these [management] reports; it must be confident that they are accurate, reliable, and contain sufficient details to allow effective monitoring."<sup>61</sup> To that end, the board should satisfy itself that the information and reporting systems in the organization are reasonably designed to provide the board timely and accurate information sufficient to allow the board to reach informed judgments.<sup>62</sup> The OCC also recommends that the board use certain key financial ratios in order to gain "good insight into bank and management performance."<sup>63</sup> In addition, the OCC notes that, when reviewing reports

prepared by management, the directors should be on alert for the appearance of "red flags" that may signal existing or potential problems and make prompt inquiry to resolve the issues raised.<sup>64</sup>

In overseeing management's performance, the board should review and monitor key business policies and procedures for conformance with the overall strategic objectives approved by the board and with the general legal, regulatory and business environment in which the organization operates. The FDIC Pocket Guide states that a banking organization should have policies that govern all significant activities of the organization and that the board should monitor the extent to which these policies "conform with changes in laws and regulations, economic conditions, and the institution's circumstances." The FDIC Pocket Guide recommends that, at a minimum, these policies should address loans (including loan review procedures), investments, asset-liability/funds management, profit planning and budget, capital planning, internal controls, compliance, audit program, conflicts of interest and code of conduct.

*Board Policies and Procedures.* In order for the board to encourage responsible, professional and ethical behavior throughout the organization, it should set clear policies and procedures to achieve its own objectives and commit to following them. These may be in the form of corporate governance guidelines and/or other policies. The OCC states that it is important for the board of a national bank to support and encourage an appropriate corporate culture and understand that this "tone at the top" shapes corporate culture and permeates the bank's relationships with its shareholders, employees, customers, suppliers, local communities and other constituents.<sup>65</sup> The Basel Committee also recommends that the board should exemplify sound governance principles through its own practices.<sup>66</sup> In its view, these practices "help the board carry out its duties more effectively" and "send important signals internally and externally about the kind of enterprise the bank aims to be."<sup>67</sup> Moreover, public companies, including public banking organizations, are required to adopt a code of conduct and make it publicly available on their websites.<sup>68</sup> TCH believes that the board of the top-tier

59 Basel Principles, at 9.

60 See, e.g., 8 Del. C. § 141(e); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); *Prince v. Bensinger*, 244 A.2d 89, 94 (Del. Ch. 1968).

61 OCC Director's Book, at 34. See also OCC Guidelines, at 126 (the bank board should "actively" oversee the bank's risk-taking activities, including by questioning, challenging, and, when necessary, opposing recommendations and decisions of management that could jeopardize the safety and soundness of the bank).

62 *In re Caremark Intern. Inc. Derivative Litigation*, 698 A. 2d 959, 970 (Del. Ch. 1996).

63 OCC Director's Book, at 42-44 (noting, for example, ratios such as return on average assets, return on equity, net interest margin, leverage ratio and net losses to average total loans); see also Department of Supervision and Regulation, The Federal Reserve Bank of Atlanta, *The Director's Primer: Guide to Management Oversight and Banking Regulation* (3rd ed. 2002) ("*Director's Primer*"), at 25-28 (describing metrics to gauge business performance of banking organizations).

64 See OCC, *Director's Toolkit—Detecting Red Flags in Board Reports* (reprint, September 2013) (February 2004) ("*OCC Director's Toolkit*"); see also *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008) (noting that directors may be liable for breach of their duty of care for knowingly ignoring "red flags").

65 OCC Director's Book, at 20. See also National Association of Corporate Directors, *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies* ("*NACD Key Agreed Principles*") (2011), at 9 ("The tone of the corporate culture is a key determinant of corporate success.").

66 Basel Principles, at 11.

67 *Id.*

68 See NYSE Manual, Section 303A.10; NASDAQ Rules, Section 5610.

entity within a banking organization should adopt such a code or codes of conduct for directors, officers and employees of the organization and that, as required of listed companies, any waivers of the code for directors or executive officers should be approved by the board or a board committee.<sup>69</sup>

*Selecting and Evaluating Management.* One of the board's most important duties is to select, retain and evaluate executive officers who are qualified to operate the organization in an effective and sound manner. The Federal Reserve Board states that the board should hire and retain officers who "meet reasonable standards of honesty, competency, executive ability and efficiency."<sup>70</sup> The OCC adds that the board or a designated board committee should actively manage the selection process of a CEO and that the selection criteria should include "integrity, technical competence, character and experience in the financial services industry."<sup>71</sup> The OCC further recommends that the board consider adopting a formal performance appraisal process to oversee management's performance because such a process "helps to ensure that periodic evaluations take place and demonstrates that the board is fulfilling its responsibility to supervise management."<sup>72</sup> For certain large national banks, the OCC Guidelines require that the bank board of directors or a board committee hire the CEO and hire or approve the hiring of the chief risk and chief audit executives.<sup>73</sup> Absent an express statutory or regulatory requirement, however, boards of directors or their designated board committees should use their judgment in determining which of the CEO's direct reports and other personnel should be approved by express board action. The board should also have flexibility to determine whether this is appropriately done at the bank level or the holding company level. Of course, the board should be very familiar with individuals appointed to senior positions, and even if the board does not formally act, it should be satisfied with those appointments and take them into account in evaluating the CEO.

As discussed in more detail in Section 8 of these Governance Principles, the board or the compensation committee also is responsible for reviewing and approving the banking organization's compensation for its senior executives and, more generally, the compensation program for other employees in light of the organization's performance. These compensation practices should be appropriately balanced such that they do not jeopardize the bank's safety and soundness. In addition, the Dodd-Frank Act imposes additional oversight responsibilities

on the boards of certain large banking organizations with respect to their compensation policies. These provisions and the rules proposed by federal bank regulators to implement them are discussed in Section 8.

Generally speaking, the background and level of expertise for senior executives will vary from company to company, and should be assessed by the board or a designated board committee in its discretion, based on the needs of the organization and the qualifications of the best candidates. Banking regulations are rarely prescriptive with respect to the specific qualifications of executives. One exception is the final rules recently adopted by the Federal Reserve Board to implement the enhanced prudential standards mandated by Section 165 of the Dodd-Frank Act (the "Federal Reserve Enhanced Standards")<sup>74</sup>, which requires that bank holding companies with total consolidated assets of \$50 billion or more appoint a chief risk officer with "experience in identifying, assessing, and managing exposures of large, complex financial firms." Absent this specific regulatory mandate, a board or the designated board committee could very well conclude that a chief risk officer with background in a non-financial firm (for example, a technology firm) might be in the best position to address the evolving risks that the organization faces and manage the risk management processes that identify and address those risks.

*Management Succession.* The board or a designated board committee also should approve an appropriate management succession plan for the CEO and review or approve management succession plans for other senior executives.<sup>75</sup> Regulators expect to see management succession plans in place that are reviewed at least annually as well as when other circumstances dictate further review or revisiting of the plan.<sup>76</sup> Within the constraints of regulatory requirements,<sup>77</sup> the board or the designated board committee should use its judgment in determining the executive positions, other than the CEO, that should be covered by succession planning, depending on the particular needs of the organization. A management succession plan can be in many forms, and need not specify definitive successors. Instead the plan often will lay out a clear process that will be implemented when a need, or potential need, for a successor arises, and may include a group of identified potential candidates. Regardless of the format, the management succession

74 See Federal Reserve Board, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations (February 18, 2014).

75 See Basel Principles, at 9; ABA Guidebook, at 13.

76 See OCC Director's Book, at 23.

77 See OCC Guidelines, at 125 (the board or a board committee of a large national bank should review and approve a written talent management program that provides for development, recruitment and succession planning regarding the CEO and the chief risk and audit executives, their direct reports and other potential successors).

69 See NYSE Manual, Section 303A.10; NASDAQ Rules, Section 5610.

70 Commercial Bank Manual, Section 5000.1, at 2.

71 OCC Director's Book, at 21.

72 *Id.* at 21-22.

73 OCC Guidelines, at 65-67 & 125.

plan should be designed to prevent a change in management from impacting the efficient operation of the organization and the continued safety and soundness of its bank subsidiaries.

*Compliance.* Because banking organizations are subject to an extensive regulatory scheme, compliance is one of the board's primary oversight responsibilities. The establishment of an enterprise-wide culture of compliance is a fundamental element of a successful compliance program, and the board and senior management should work to create a "tone at the top" emphasizing the importance of compliance at every level.

The board of a banking organization has the ultimate responsibility for overseeing management's establishment and implementation or operation of a system designed to promote compliance with applicable laws and regulations. To that end, the board or the audit committee should supervise management's creation of clear policies that govern and guide the day-to-day operations of the organization to comply with applicable laws and regulations, including internal and external audit processes<sup>78</sup> and disclosure controls and procedures, and the board or the audit committee should review these policies from time to time in light of changing legal requirements, as described further above under *Monitoring Management Performance*. As discussed further in Section 6 of these Governance Principles, as part of its compliance oversight function, the board (acting through the audit committee or another independent committee) also should review and approve a process for the treatment of "whistleblower" claims or other reports by employees or other parties regarding compliance issues.

The FDIC Pocket Guide also recommends that the board adopt "a mechanism for independent third party review and testing" of compliance with policies and procedures of the banking organization and applicable laws and regulations, as well as the accuracy of information provided by management.<sup>79</sup> The FDIC Pocket Guide suggests that such independent review may be "accomplished by an internal auditor reporting directly to the board, or by an examining committee of the board itself."<sup>80</sup>

Furthermore, the board should meet with federal and state bank examiners during or at the conclusion of the examination process and carefully review examination reports in order to supervise management's efforts to strengthen the organization's compliance programs and policies. The structure and frequency of such meetings with both bank examiners and the regulators more broadly are discussed in greater detail in Section 15 of these Governance Principles.

*Risk Management.* Risk management, including the advancement of a sound risk culture, is a crucial aspect of the oversight role of the board of a banking organization. The Basel Committee states that the board should approve and monitor the banking organization's "policies for risk, risk management and compliance" and internal controls systems as part of its oversight responsibilities.<sup>81</sup> The Financial Stability Board (the "FSB"), an international body of financial regulatory authorities, has stressed the critical role of the board of directors, along with senior management, in setting the "tone at the top" from a risk perspective, including by "clearly articulating the underlying values that support the desired risk culture and behaviours; recognising, promoting and rewarding behaviour that reflects the stated risk culture and its core values; and systematically monitoring and assessing the actual culture."<sup>82</sup> The Federal Reserve Board recommends that the board review and approve risk management policies that are "primarily intended to ensure that the risks undertaken by the banks are prudent and are being properly managed."<sup>83</sup> The Federal Reserve Board also emphasizes that it is crucial for the board to "have a fundamental understanding of the various types of risks associated with different aspects of the banking business, for example, credit risk, foreign exchange risk, or interest rate risk, and define the types of risks the [banking organization] will undertake."<sup>84</sup> The OCC further recommends that the board and management work together to create a risk management system that identifies, measures, monitors and controls risks faced by the bank.<sup>85</sup> In addition, the recently finalized OCC Guidelines impose substantial risk management-related and other responsibilities on the boards of directors of certain large national banks. Among other things, the OCC Guidelines require the boards of directors to "actively"

78 See Federal Reserve Board, Supplemental Policy Statement on the Internal Audit Function and its Outsourcing, SR 13-1, at 7 (January 23, 2013) (describing the responsibilities of the board of directors and audit committee with respect to oversight of internal audit and internal audit outsourcing arrangements).

79 See also OCC Guidelines, at 39 (noting that front line units, independent risk management and internal audit would find it "useful" to engage the services of external experts).

80 See also OCC Director's Book, at 35 ("A board may evaluate whether it is meeting its oversight responsibilities through a comprehensive audit and control program.").

81 Basel Principles, at 8.

82 Financial Stability Board, Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture (April 7, 2014).

83 Commercial Bank Manual, Section 5000.1, at 2; see also OCC Director's Book, at 10 (noting that the board of a national bank should oversee the bank's risk tolerance by approving written policies that "set standards for the nature and level of risk the bank is willing to assume" and periodically review and update such policies).

84 Commercial Bank Manual, Section 5000.1, at 2.

85 OCC Director's Book, at 11-12.

oversee the banks' risk-taking activities.<sup>86</sup> The Guidelines also require the boards of directors (or the boards' risk committees) to approve a formal, written risk governance framework that includes three distinct functions—front line units, independent risk management and internal audit—and to approve any significant changes to the risk governance framework.<sup>87</sup> The board also should review the maintenance of sufficient capital levels in light of the organization's risk profile as Congress and bank regulators have increasingly emphasized the importance of capital planning in the aftermath of the financial crisis of 2008.<sup>88</sup>

Additionally, the Federal Reserve Board recently has finalized rules to implement the enhanced prudential standards mandated by Section 165 of the Dodd-Frank Act.<sup>89</sup> The final Federal Reserve Enhanced Standards include a wide range of measures addressing capital, liquidity, stress testing and risk management, and impose a number of specific duties on the board of directors. As discussed further in Section 9 of these Governance Principles, the final rules require bank holding companies with total consolidated assets of \$50 billion or more and publicly traded bank holding companies with total consolidated assets of \$10 billion or more to have a risk committee of the board (for bank holding companies with total consolidated assets of \$50 billion or more, this risk committee is required to be a *stand-alone* committee of the board) that will oversee enterprise-wide risk management. The final rules also establish minimum requirements governing the frequency of certain reviews and approvals by the board and the risk committee.<sup>90</sup> Specifically, under the final rules, the board of directors of a bank holding company with total consolidated assets of \$50 billion or more is required to approve the company's

liquidity risk tolerance—the acceptable level of liquidity risk that the company may assume in connection with its operating strategies, taking into account factors such as capital structure, risk profile, complexity, activities and size—at least annually.<sup>91</sup> The board of directors also is required to review, at least semi-annually, information provided by senior management to determine whether the company is operating within its established liquidity risk tolerance, and to approve and periodically review the liquidity risk management strategies, policies and procedures established by senior management.<sup>92</sup> In addition, the risk committee or a designated subcommittee of the risk committee is required to review and approve the company's contingency funding plan at least annually and whenever the company materially revises the plan.<sup>93</sup> Finally, the final rules require these bank holding companies to have a review function, which is independent of management functions, to evaluate the company's liquidity risk management.<sup>94</sup>

Although the final Federal Reserve Enhanced Standards do include detailed provisions with respect to the responsibilities of the board of directors and its risk committee, the final rules were modified from the proposal in order to allocate to management some of the duties that the proposed rules would have imposed on the board. For example, the board of directors is charged with approving liquidity risk tolerance, as opposed to setting it. These changes were responsive to comments received on the proposal raising the concern that the proposal did not appropriately recognize the oversight role of boards of directors and their committees as compared to the day-to-day management role of senior management.<sup>95</sup>

TCH believes that, for most banking organizations, it is appropriate for the holding company board to have meetings at least annually with a focused discussion of capital planning, resolution plans and risk management, including liquidity risk management. The role of the board in capital planning, including under stress scenarios, is

86 OCC Guidelines, at 73-74 & 126. The OCC clarified that the board of directors may rely on risk assessments and reports prepared by independent risk management and internal audit to meet its responsibilities to provide active oversight. *Id.*

87 *Id.* at 114 & 126. The board of directors or the board's risk committee would also be required to review and approve the bank's risk appetite statement that serves as the basis of the risk governance framework at least annually or more frequently, as necessary, and to review and approve a three-year strategic plan developed under the direction of the CEO that includes a comprehensive risk assessment. *Id.* at 120-122.

88 See Dodd-Frank Act, § 171(b)(2); see, e.g., OCC, Federal Reserve Board, FDIC, Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor, 76 Fed. Reg. 37,620 (June 28, 2011); OCC, Department of Treasury, Federal Reserve Board, Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (October 11, 2013); OCC, Department of Treasury, Federal Reserve Board, FDIC, Proposed Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring, 78 Fed. Reg. 71,818 (November 29, 2013).

89 See Federal Reserve Enhanced Standards.

90 *Id.* §§ 252.22(c) & 252.33(a)(3).

91 *Id.* § 252.34(a)(1). For matters that require actions of the full board, the board may determine that its actions should be based on recommendations of the risk committee.

92 *Id.* § 252.34(a)(1) & (2).

93 *Id.* § 252.34(b).

94 *Id.* § 252.34(d).

95 Similarly, the final OCC Guidelines included certain changes from the January 2014 proposal, in response to comments received, that were intended to avoid assigning "managerial responsibilities" to, or otherwise operationally overburdening, the board or the risk committee. OCC Guidelines at 31, 36, 52, 67, 71, 72 & 74.

an increasing focus of regulatory scrutiny.<sup>96</sup> Subject to applicable regulatory requirements, the board should have flexibility in delegating some of its risk oversight responsibilities to its risk committee.

Resolution plans, or “living wills,” have emerged as an area of supervisory and regulatory focus in the aftermath of the 2008 global financial crisis. Section 165(d) of the Dodd-Frank Act and the implementing regulations require large bank holding companies with total consolidated assets of \$50 billion or more to develop, maintain and periodically report to the regulators on their plans for “rapid and orderly resolution in the event of material financial distress or failure” under the U.S. Bankruptcy Code in a way that would not pose systemic risk to the financial system.<sup>97</sup> Pursuant to these regulations, the boards of these large bank holding companies and depository institutions are required to approve an initial resolution plan and subsequent annual resolution plans and such approvals should be duly noted in the minutes of meeting of the board of directors.<sup>98</sup>

*Community Credit Needs.* Federal bank regulators emphasize that the board of a banking organization should review the banking organization’s efforts to meet the community’s credit needs. For instance, the Federal Reserve Board declares that the board of a member bank has “a continuing responsibility to provide those banking services which meet the legitimate credit and other needs of the community being served.”<sup>99</sup> In a similar vein, the OCC notes that a national bank’s charter imposes “significant responsibilities to serve the community.”<sup>100</sup> The OCC recommends that a board “evaluate whether any areas of the bank’s community have credit needs that are unmet and whether any changes to the bank’s current plans or policies are appropriate” and “consider whether otherwise sound policies and procedures could have the unintended effect of discouraging good quality business

in older and low or moderate income neighborhoods.”<sup>101</sup> TCH believes that it would be appropriate for the board or a board committee of a banking organization to monitor the effectiveness of the organization’s effort to meet community credit through its oversight of management’s overall compliance process.

*Related Party Transactions.* For U.S. public companies, the SEC proxy rules require a description of the company’s policies and procedures for the review, approval or ratification of specified transactions or relationships involving the company and any director, executive officer or 5% shareholder.<sup>102</sup> Among the disclosure requirements are the “persons or groups of persons on the board of directors or otherwise who are responsible for applying such policies and procedures.”<sup>103</sup> Although this disclosure requirement does not require board or board committee participation in the process, TCH believes that the board or an appropriate committee (e.g., the nominating/corporate governance committee) should guide the development of the related party approval policy and have ultimate authority on the approval or denial of any proposed related party transactions that require an exception, particularly transactions involving directors.

In guiding the development of related party approval policies, the board of a banking organization or the designated board committee also should take into account the provisions of Sections 23A and 23B of the Federal Reserve Act. Sections 23A and 23B impose limitations on, and require market terms and conditions for, certain transactions between a bank and its affiliates (including any company that controls, or is under common control with, the bank, other than certain subsidiaries of the bank).<sup>104</sup> In addition, Sections 22(g) and (h) of the Federal Reserve Act place restrictions on loans by a member bank to any of its executive officers, directors and principal shareholders.<sup>105</sup> Pursuant to Section 22(h) and Regulation O, a member bank may not extend credit or grant a line of credit to any of its executive officers, directors, or principal shareholders or to any related interest of any such person in an amount greater than prescribed limits unless the extension of credit or line of credit has been approved in advance by a majority of the entire board of directors of the bank (with any interested director abstaining).<sup>106</sup> Furthermore, Section 22(g) and Regulation O impose additional restrictions on loans to any executive officer.<sup>107</sup> Publicly traded banking organizations are subject to

96 See Federal Reserve Board, Capital Plans, 76 Fed. Reg. 74,631, 74,632 (December 1, 2011) (requiring bank holding companies with \$50 billion or more in total consolidated assets to submit capital plans to the Federal Reserve Board on an annual basis and noting that “the board of directors and senior management bear the primary responsibility for developing, implementing, and monitoring a bank holding company’s capital planning strategies and internal capital adequacy process”).

97 See FDIC and Federal Reserve Board, Resolution Plans Required, 76 Fed. Reg. 67,323 (November 1, 2011) (“Resolution Plan Requirements”); FDIC, Resolution Plans Required for Insured Depository Institutions with \$50 billion or More in Total Assets (September 10, 2011) (“Interim Resolution Plan Rule”) (requiring resolution plans for large depository institutions with total consolidated assets of \$50 billion or more).

98 See Resolution Plan Requirements, at 67,331; Interim Resolution Plan Rule, at 53.

99 Commercial Bank Manual, Section 5000.1, at 4; see also FDIC Pocket Guide (noting the board’s role in a banking organization’s efforts to help “meet its community’s credit needs”).

100 OCC Director’s Book, at 47; see also 12 C.F.R. § 25.25(c) (outlining the criteria by which the OCC assesses a bank’s record of helping to meet the credit needs of its entire community).

101 OCC Director’s Book, at 48.

102 See Item 404(b) of Regulation S-K.

103 *Id.*

104 See 12 U.S.C. §§ 371c and 371c-1.

105 See 12 U.S.C. §§ 375a and 375b.

106 See 12 U.S.C. § 375b; 12 C.F.R. § 215.4.

107 See 12 U.S.C. § 375a; 12 C.F.R. § 215.4.

additional restrictions set forth in Section 402 of the Sarbanes-Oxley Act of 2002<sup>108</sup> (the “Sarbanes-Oxley Act”), which prohibits public companies and their subsidiaries from extending or arranging personal loans to or for their directors and executive officers, subject to certain exceptions.<sup>109</sup>

More generally, federal bank regulators recognize that transactions between a banking organization and its directors may sometimes be important to the banking organization but caution that such transactions always should be “at arm’s length” and “avoid even the appearance of a conflict of interest.”<sup>110</sup> The OCC further states that the director with a potential conflict of interest should refrain from “discussing, voting, or having any other involvement in the matter” and that the board’s discussion and approval of a transaction between a director and the bank should be fully documented through (i) independent appraisals or other information showing the competitiveness of the terms or comparability to transactions with non-insiders and (ii) board minutes that reflect the nature of the board’s deliberations regarding the potential conflict of interest and its compliance with applicable legal and regulatory requirements.<sup>111</sup> Similarly, the Federal Reserve Board recommends that interested director(s) abstain from voting on transactions between a banking organization and the director(s) and that such abstention be recorded in the minutes.<sup>112</sup>

## Section 5. Board Committees

### **Principles:**

- (a) The board of the top-tier entity within a banking organization should establish board committees to assist the board in its oversight of (i) audit, (ii) nominating/corporate governance, (iii) compensation and (iv) risk management activities, as well as any other standing or temporary committees appropriate to the circumstances and businesses of the banking organization.**
- (b) The responsibilities of each standing committee should be described in a written charter or similar document. Certain matters might be within the scope of two or more committees (e.g., audit and**

**risk management), in which case the relevant committees should coordinate as appropriate.**

- (c) The standing committees should report regularly to the full board. The board should adopt a schedule for the reports to be delivered by each committee, recognizing that it may be appropriate for some committees to report more frequently than others.**

### **Commentary:**

#### Committee Structure

The board of a banking organization should have an organizational structure that enables it to oversee the affairs of the organization in a sound manner. The OCC advises that a board should “carefully consider the extent and nature of the demands that are placed on it” and identify areas where it would benefit from a division of labor and the expertise of certain directors through the creation of appropriate committees.<sup>113</sup> Similarly, the Federal Reserve Board notes that many boards “elect to delegate some of their workload to committees” and that the “extent and nature of the bank’s activities and the relative expertise of each board member play key roles in the board’s determination of which committees to establish, who sits on them, and how much authority they have.”<sup>114</sup> Accordingly, the board should create board committees and delegate responsibilities to such committees in a manner that is tailored to the particular circumstances and businesses of the organization. The review of a board’s committee structure may be done by the board itself or by a committee charged with oversight of corporate governance as described in Section 7 of these Governance Principles.

Although there is no single “ideal” committee structure that is applicable to all banking organizations, the board of the top-tier entity within a banking organization normally will have at least the committees discussed in the following sections (audit, nominating/corporate governance, compensation and risk management). The banking organization should be able to combine these functions into fewer committees or separate them into additional committees, as the board deems appropriate, if the focus and integrity of the committees are not compromised and the members meet all relevant independence and qualification criteria. In this regard, the Federal Reserve Enhanced Standards require bank holding companies with total consolidated assets of \$50 billion or more to establish a stand-alone risk committee, as discussed further in Section 9 of these Governance Principles. The audit, nominating/corporate governance and compensation committees generally are mandated by

108 Pub. L. No. 107-204, 116 Stat. 745.

109 Sarbanes-Oxley Act, § 402; Section 13(k) of the Exchange Act (15 U.S.C. § 78m).

110 OCC Director’s Book, at 74.

111 *Id.* at 75-76.

112 Commercial Bank Manual, Section 5000.1, at 3; see also ABA Guidebook, at 24 (suggesting that directors should refrain from engaging in any transaction with the corporation on the other side unless the underlying action is demonstrably fair or has been approved by the disinterested directors or shareholders of the corporation after full disclosure).

113 OCC Director’s Book, at 27-28.

114 Commercial Bank Manual, Section 5000.1, at 4.

securities exchange and SEC rules applicable to all listed public companies.<sup>115</sup>

The mandates of separate board committees will in many cases overlap – for example, management succession and director compensation may be appropriate for consideration by both the nominating/corporate governance committee and the compensation committee, and risk-related concerns can arise from the subjects discussed by all of the committees, not just the risk committee. Boards may determine that having overlapping membership among committees and, in appropriate cases, joint meetings of separate committees, can allow directors to operate efficiently and with a common knowledge base, and facilitate the board's broad oversight of the organization. Joint membership and joint meetings may be particularly helpful for companies with a standalone risk committee, as discussed further in Section 9 of these Governance Principles.

Banking organizations also may deem it appropriate to have some or all these committees at the subsidiary bank level depending on the size and complexity of such subsidiary bank's operations.<sup>116</sup> Pursuant to regulations adopted by the FDIC under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), banking organizations with total assets of \$500 million or more are required to establish an audit committee.<sup>117</sup> This requirement, however, may be satisfied by an audit committee at the holding company level with respect to subsidiary banks that have consolidated total assets comprising 75% or more of the holding company's consolidated total assets, subject to certain conditions.<sup>118</sup> The OCC also suggests that an audit committee may be unnecessary at the bank level if there already is a similar committee at the holding company level.<sup>119</sup> More generally, the OCC observes that the "best committee structure for a bank depends on the bank's size, scope of operation, and risk profile, the board's composition, and individual directors' expertise."<sup>120</sup>

Many corporations, including many banking organizations, have an executive committee that is empowered to act on the board's behalf when the full board is unable to meet (*e.g.*, between regular board meetings). The OCC states that the executive committee should review all major bank functions but cautions that the committee should not "have the authority to exercise all board powers" such as "the right to execute extraordinary contracts such as mergers and acquisitions."<sup>121</sup> Similarly, the general corporate law in most states allow boards to grant executive committees broad powers, other than certain specified actions such as amending the bylaws of the corporation or submitting matters to shareholders for approval.<sup>122</sup> TCH believes that the authority and constituency of an executive committee should be determined by the board, based on the structure of the particular organization, including how frequently the board is called upon to act between regular board meetings. The board may consider whether its use of the executive committee should be limited in any respect beyond that legally required so as not to impinge on the role of the full board and the diversity of opinion that the board will bring to bear on an issue.

Each standing committee should have a written charter that outlines a "clear statement of its mission, authority, responsibility, and duration."<sup>123</sup> According to the OCC, "Committee charters help ensure that important board functions are not neglected because of misunderstandings or incomplete delegations."<sup>124</sup> Committee charters also can help clarify, and avoid excessive overlap between, the roles of the various committees. It should be recognized, however, that certain committees will have some closely related or overlapping responsibilities due to the nature of their respective functions. For example, the audit and risk committees may both meet periodically with management and the internal and external auditors to review the adequacy of the organization's controls. Such overlapping responsibility is unavoidable and also not necessarily detrimental because the audit committee will conduct such meetings with a view towards reviewing the quality of the organization's financial reporting procedures while the risk committee will do the same in order to better understand and supervise the organization's risk profile.

The board of a banking organization also may find it desirable to create additional standing or temporary

115 See Exchange Act Rule 10A-3(b)(1)(ii); NYSE Manual, Sections 303A.04, 303A.05 and 303A.06; NASDAQ Rules, Sections 5605(c)(2)(A), 5605(d)(2)(A) and 5605(e)(1)(B).

116 Following the events of the 2008 financial crisis, there has been a greater focus on the governance of legal entities within a group structure. See Basel Principles, at 15 ("In a group structure, the board of the parent company has the overall responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risks of the group and its entities.").

117 12 C.F.R. § 363.5.

118 See 12 C.F.R. Pt. 363, App. A.

119 See OCC Director's Book, at 30 ("In certain circumstances, [audit committee] requirements may be met at the holding company level.").

120 OCC Director's Book, at 28.

121 *Id.* at 29.

122 See, *e.g.*, 8 Del. C. § 141(c)(2).

123 OCC Director's Book, at 28; see also NYSE Manual, Sections 303A.07(b), 303A.05(b), and 303A.04(b) (requiring the audit, compensation and nominating/corporate governance committees of public companies to have written charters specifying the duties of those committees pursuant to the rules of the national securities exchanges); ABA Guidebook, at 63.

124 OCC Director's Book, at 28.

committees based on the size and complexity of the organization and the needs and circumstances it faces from time to time. As the Federal Reserve Board has observed, “[D]epending on the nature and complexity of the bank’s business, the board may establish other committees to monitor such areas as trust, branching, new facilities construction, personnel/human resources, electronic data processing, and consumer compliance.”<sup>125</sup> For instance, banking organizations may consider establishing a loan committee in order to obtain the benefits of Section 13(e) of the Federal Deposit Insurance Act (“FDIA”), which provides that a contract may not be enforced against the FDIC, whether acting as a receiver or as liquidator, unless (among other things) it was approved by “the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee.”<sup>126</sup>

### The Relationship Between the Board and its Committees

State corporate law generally allows board committees to perform most board functions,<sup>127</sup> and references in these Governance Principles to actions to be taken by the “board” generally include actions taken through board committees. Nevertheless, the delegation of responsibilities and functions to standing or temporary committees does not relieve the full board of general oversight responsibility over those functions.<sup>128</sup> Moreover, the ABA states that, “[i]n accord with [the board’s] obligation to provide oversight,” the board committees should adopt proper procedures providing a regular flow of reports and other information to the board such that all directors are kept “abreast of each committee’s activities and significant decisions.”<sup>129</sup> Both standing and temporary committees should keep the board informed of their activities through reports at board meetings, and the board should consider adopting a formal schedule for delivery of these reports. These reports should

<sup>125</sup> Commercial Bank Manual, Section 5000.1, at 5; see also OCC Director’s Book, at 28 (“The best committee structure for a bank depends on the bank’s size, scope of operation, and risk profile, the board’s composition, and individual directors’ expertise.”).

<sup>126</sup> 12 U.S.C. § 1823(e)(1)(C); see also OCC Director’s Book, at 31 (discussing establishment and role of a loan committee).

<sup>127</sup> See, e.g., 8 Del. C. § 141(c)(2) (stating that, subject to certain exceptions, a board committee “may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation”).

<sup>128</sup> See Walker Review, at 90 (noting that the creation of a committee does not replace ultimate responsibility and accountability of the whole board for such committee’s function).

<sup>129</sup> ABA Guidebook, at 61; see also *id.* at 64 (“Board committees should regularly inform the board of their activities. Generally, standing committees should provide reports at regularly scheduled full board meetings and circulate to all directors committee agendas, minutes, and written reports . . . .”); OCC Director’s Book, at 28 (“Committees should report regularly to the board.”).

summarize all significant decisions and actions taken at the committee meetings.

### Section 6. Audit Committees and Board Oversight of Financial Reporting and Audit Functions

#### **Principles:**

- (a) **The board of the top-tier entity within a banking organization should have an audit committee, composed entirely of independent directors, with sole authority to appoint, terminate and approve compensation for independent auditors.**
- (b) **The members of the audit committee of the top-tier entity collectively should have appropriate accounting, banking and related financial expertise and experience, including at least one member who is an audit committee financial expert under SEC rules.**
- (c) **The audit committee, or another independent committee, should review and approve procedures for the receipt, retention and treatment of complaints regarding compliance issues, including confidential, anonymous submissions by employees or other parties of accounting or auditing concerns.**

#### **Commentary:**

##### Responsibilities of the Audit Committee

The importance of an independent, qualified and engaged audit committee as a governance matter has been widely recognized. In the wake of several prominent accounting scandals, Congress passed the Sarbanes-Oxley Act, which, among other things, directed the SEC and the national securities exchanges to require public companies to create an audit committee and to prescribe specific qualifications for members of the audit committee.<sup>130</sup> After the promulgations of rules and regulations by the SEC and the national securities exchanges pursuant to these directives, federal bank regulators adopted similar regulations applicable to banking organizations with total consolidated assets of \$500 million or more.<sup>131</sup>

Broadly stated, the audit committee has general oversight responsibility for a banking organization’s financial reporting process, internal controls, internal audit (including any outsourcing of internal audit functions)<sup>132</sup> and compliance policies and procedures,

<sup>130</sup> Sarbanes-Oxley Act, § 301.

<sup>131</sup> See, e.g., 12 C.F.R. § 363.5.

<sup>132</sup> See Federal Reserve Board, Supplemental Policy Statement on the Internal Audit Function and its Outsourcing, SR 13-1, at 7 (January 23, 2013) (describing the responsibilities of the board of directors and audit committee with respect to oversight of internal audit and internal audit outsourcing arrangements).

as well as responsibility for hiring and communicating with the banking organization's external auditors.<sup>133</sup> The Sarbanes-Oxley Act and accompanying regulations impose specific responsibilities on the audit committees of public companies, including the following: (i) selecting and engaging the external auditor and annually deciding whether to retain the external auditor, and reviewing and approving annually the external auditor's fee arrangement, (ii) overseeing the organization's procedures for issuing quarterly and annual earnings press releases and for providing financial information and earnings guidance to analysts, the financial press and rating agencies, and (iii) determining whether to recommend to the board that the audited annual financial statements of the organization be included in its annual report on Form 10-K.<sup>134</sup>

As part of the board's compliance oversight function, the audit committee (or another independent committee) should review and approve a process for the treatment of "whistleblower" claims or other reports by employees or other parties regarding compliance issues. Under SEC rules, the audit committees of public companies must establish procedures for the receipt, retention and treatment of complaints regarding accounting or auditing matters and for the confidential, anonymous submission by employees of accounting or auditing concerns.<sup>135</sup> Bank regulators also have recommended the use of a confidential reporting system through which the board gives "prompt attention to ethics lapses and other inappropriate or illegal activity."<sup>136</sup> The structure of such reporting systems, including the specific role of the board or audit committee, and the reliance on management

for administrative support, will vary based on each organization's particular structure and the type of report.

The board of the holding company should determine, as part of its oversight of the responsibilities and structure of subsidiary bank boards, whether the bank board should have its own audit committee (as well as other committees), subject to relevant regulatory requirements. Such determination should receive the concurrence of the subsidiary bank board. As noted in Section 5 above, banking organizations with total assets of \$500 million or more are required to establish an audit committee pursuant to federal bank regulations.<sup>137</sup> This requirement, however, may be satisfied by an audit committee at the holding company level with respect to subsidiary banks that have consolidated total assets comprising 75% or more of the holding company's consolidated total assets, subject to certain conditions.<sup>138</sup> Regardless of whether the subsidiary bank has its own audit committee, the bank board should be composed of individuals who collectively have the financial knowledge necessary to perform their oversight responsibilities effectively.

#### Composition of the Audit Committee

After the passage of the Sarbanes-Oxley Act, the SEC, the national securities exchanges and federal bank regulators adopted regulations requiring all public (and certain large private) banking organizations to create an audit committee of the board composed entirely of independent directors with certain prescribed qualifications.<sup>139</sup> The audit committee of banking organizations with assets greater than \$3 billion must "include members with banking or related financial management expertise."<sup>140</sup> Similarly, pursuant to rules adopted by the national securities exchanges, members of the audit committee of a public company generally must be "financially literate" and at least one member of the audit committee must have "accounting or related financial management expertise" (as such terms are interpreted by the board in its business judgment).<sup>141</sup> Finally, Item 407(d)(5) of Regulation S-K requires a public company, including a public banking organization, to disclose whether an "audit committee financial expert" serves on the audit committee. The term "audit committee financial expert" is defined as a person who has:

- (i) an understanding of generally accepted accounting principles and financial statements;

133 See Commercial Bank Manual, Section 5000.1, at 5 (noting that the audit committee typically "monitors compliance with bank policies and procedures, and reviews internal and external audit reports and bank examination reports"); OCC Director's Book, at 29 ("An audit committee performs a key role because it oversees the audit function and financial reporting processes and helps strengthen communication between management and the auditors."); ABA Guidebook, at 65 (noting that the audit committee "is critical to the corporate governance structure" and "has general oversight responsibility for the company's financial reporting process and internal controls"). See also Basel Committee on Banking Supervision, *The Internal Audit Function in Banks* (June 2012), Annex 2—Responsibilities of a bank's audit committee, at 21.

134 See 12 C.F.R. § 363.5; Exchange Act Rule 10A-3; NYSE Manual, Section 303A.06; NASDAQ Rules, Section 5605(c).

135 See Exchange Act Rule 10A-3(b)(3). On May 25, 2011, pursuant to the directive of Section 922(a) of the Dodd-Frank Act, the SEC adopted final rules implementing a whistleblower program designed to encourage tips of potential federal securities law violations to the SEC. The program reinforces the need for boards to continually review and improve their internal reporting and compliance systems. See 17 C.F.R. 240.21.

136 OCC Director's Book, at 40; see also Basel Principles, at 9 (suggesting that banking organizations should establish a policy setting forth adequate procedures for employees to communicate confidentially material and bona fide concerns or observations of any illegal, unethical or questionable practices, and that the board should determine how and by whom such legitimate concerns shall be investigated and addressed).

137 See 12 C.F.R. § 363.5.

138 See 12 C.F.R. Pt. 363, App. A.

139 See Sarbanes-Oxley Act, § 301; 12 C.F.R. § 363.5; Exchange Act Rule 10A-3; NYSE Manual, Section 303A.06; NASDAQ Rules, Section 5605(c)(2).

140 12 C.F.R. § 363.5(b); see also OCC Director's Book, at 30 ("The audit committee of a large bank must include members with banking or related financial expertise.").

141 NYSE Manual, Section 303A.07 (commentary).

- (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- (iii) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that generally are comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- (iv) an understanding of internal control over financial reporting; and
- (v) an understanding of audit committee functions.<sup>142</sup>

TCH believes that the board of the top-tier entity within a banking organization should have at least one member of the audit committee designated as an audit committee financial expert under SEC rules. Although nothing in the SEC rules or banking regulations absolutely requires a board to have an audit committee financial expert and there are arguments that an otherwise qualified board with access to outside financial expertise may function just as effectively, TCH believes that having such an expert on the audit committee enhances the committee's capability to address the complex issues it will face and is consistent with regulatory and market expectations.

Section 7. [Nominating/Corporate Governance Committees, Director Qualifications and Board Oversight of Director Nomination Process](#)

**Principles:**

- (a) The board of the top-tier entity within a banking organization should have a committee, composed entirely of independent directors, to conduct the director nomination process and assess the qualifications and independence of director candidates.**
- (b) This committee should establish factors to be considered in evaluating prospective director nominees and in evaluating directors for membership on board committees, taking into account the circumstances and businesses of the banking organization and the responsibilities of the various committees.**
- (c) The board of the top-tier entity within a banking organization should have a committee, composed entirely of independent directors, with responsibility for corporate governance, including responsibility for the board self-evaluation**

<sup>142</sup> Regulation S-K, Item 407(d)(5)(ii).

**process and advice and assistance to the board in overseeing the entity's corporate governance structures, processes and performance.**

- (d) The nominating and corporate governance committee functions may be joined together, may be undertaken by separate independent committees or may be apportioned to independent committees that have other functions.**

**Commentary:**

Pursuant to the rules of the national securities exchanges, public companies generally are required to have a nominating committee composed entirely of independent directors.<sup>143</sup> According to the OCC, the nominating committee generally "recommends nominees for election as directors and may recommend successors to key management positions when positions become vacant."<sup>144</sup> The NYSE listing standards contemplate that this committee also will oversee corporate governance matters, though they indicated that it is acceptable for an organization to have separate committees discharging these functions, so long as each committee is composed of independent directors.<sup>145</sup>

Because the holding company controls the voting securities of the subsidiary bank and establishes the corporate governance practices for the whole organization, TCH believes it is acceptable for there to be no separate nominating/corporate governance committee at the wholly owned subsidiary bank level.

**Qualifications of Directors**

Federal and state banking statutes prescribe certain citizenship and residency requirements for directors of banks but not bank holding companies. For instance, directors of national banks must generally be U.S. citizens, and a majority of the directors must have resided in the state, territory, or district in which the bank is located for at least one year immediately prior to election to the board (though the OCC may, in its discretion, waive the residency requirement and, in the case of not more than a minority of the total number of directors, the citizenship

<sup>143</sup> NYSE Manual, Section 303A.04; NASDAQ Rules, Section 5605(e)(1)(B).

<sup>144</sup> OCC Director's Book, at 33; see also ABA Guidebook, at 97 (noting that the nominating and governance committee is "responsible for recruiting and maintaining board members").

<sup>145</sup> For convenience, we refer in these Governance Principles to a "nominating/corporate governance committee" because most organizations combine these functions. If these functions are performed by separate committees, the committees should coordinate as appropriate. See NYSE Manual, Section 303A.04.

requirement).<sup>146</sup> Besides complying with these basic requirements, all banking organizations should attempt to ensure that their directors have the requisite qualifications and experience to enable them to exercise sound judgment and oversee the affairs of the organization. The duty of director nomination is critical because the ultimate determinant of effective corporate governance consists of the quality, skills and expertise of the individuals who comprise the board and the management of the banking organization.

Ordinarily, the nominating/corporate governance committee of the board should establish, or recommend to the board, the parameters for qualifications of directors. Typically, these do not consist of objective qualifications or disqualifications but rather lists of factors that the committee should use to assess candidates.<sup>147</sup> Bank regulators have set out general considerations regarding the qualifications of directors of banking organizations. For instance, the OCC states that the qualifications of directors of national banks should include:

- (i) basic knowledge of the banking industry, the financial regulatory system and the laws and regulations that govern the operation of the institution;
- (ii) willingness to put the interests of the bank ahead of personal interests;
- (iii) willingness to avoid conflicts of interests;
- (iv) knowledge of the communities served by the bank;
- (v) background, knowledge and experience in business or another discipline to facilitate oversight of the bank; and
- (vi) willingness and ability to commit the time necessary to prepare for and regularly attend board and committee meetings.<sup>148</sup>

Similarly, the Basel Committee recommends that directors of banking organizations have “adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue in order to enable effective governance and oversight.”<sup>149</sup> The Basel

Committee adds that the board of a banking organization should include directors who collectively have “appropriate experience or expertise” in areas such as “finance, accounting, lending, bank operations and payment systems, strategic planning, communications, governance, risk management, internal controls, bank regulation, auditing and compliance.”<sup>150</sup> The nominating/corporate governance committee should take into account factors such as the ones recommended by bank regulators and also establish parameters for qualifications based on the particular circumstances and businesses of the banking organization. As noted by the ABA, “there is no one-size-fits-all approach to director searches.”<sup>151</sup>

The parameters established by the nominating/corporate governance committee should address the independence concerns discussed in Section 2 of these Governance Principles and also help the board develop an appropriate level of diversity, including demographic diversity, diversity of backgrounds and viewpoints, and diversity in areas of expertise and professional experience (such as technology or relevant business experience pertinent to the bank’s business).<sup>152</sup> Many banking organizations have found that deliberate efforts to expand diversity of board members have yielded more vibrant, engaged and forward-thinking boards of directors. As discussed further in Section 4 of these Governance Principles with respect to the risk committee in particular, a nominating/corporate governance committee may determine that having a number of directors with experience outside of the financial industry could provide helpful additional perspectives to the board.

The nominating/corporate governance committee should focus on the strengths and weaknesses of the organization, its board and board committees, and its strategic objectives and plans, and establish parameters that will attract director candidates who can provide needed additional talent and experience that will advance the governance and development of the organization.<sup>153</sup> When considering director candidates, the nominating/corporate governance committee also should consider the candidate’s compatibility with the organization’s corporate culture and strategic objectives, as well as any criteria applicable to board committee membership, such as identifying a director who qualifies as an “audit committee financial expert” for the audit committee and a director with risk management expertise for the risk committee.<sup>154</sup> The nominating/corporate

146 12 U.S.C. § 72; see also N.Y. Banking Law § 7001(2)(a) (“At least one-half of the directors of a bank or trust company, stock form savings bank, or stock form savings and loan association must be citizens of the United States at the time of their election and during their continuance in office.”).

147 See OCC Director’s Book, at 33 (describing the role of the nominating/corporate governance committee in recommending nominees for election as directors); NYSE Manual, Section 303A.04 (stating that the nominating/corporate governance committee must have the responsibility to “identify individuals qualified to become board members, consistent with criteria approved by the board”).

148 OCC Director’s Book, at 4-5.

149 Basel Principles, at 10.

150 *Id.*

151 ABA Guidebook, at 99.

152 See OCC Director’s Book, at 4 (“Many banks nominate directors on the basis of their independence, diversity, technical qualifications, and capabilities.”).

153 ABA Guidebook, at 99.

154 *Id.* at 98-99.

governance committee should consider whether a candidate for director nomination or re-nomination can commit the necessary time to satisfy director responsibilities; in this regard, the committee or the board may wish to consider adopting policies requiring directors to inform the company of a change in principal occupation or business association or of intentions to serve on a board or in an executive position of another company.<sup>155</sup>

In addition, the nominating/corporate governance committee should be the “conduit for communication regarding shareholder recommendations for director nominees.”<sup>156</sup> In this regard, it is worth noting that, following the effectiveness in September 2011 of the amendments to Exchange Act Rule 14a-8, eligible shareholders of a public company can now use the company’s proxy materials to propose proxy access bylaws and other director nomination procedures.<sup>157</sup> The nominating/corporate governance committee will, in many cases, play a key role in formulating a public company’s response to proxy access proposals and the evaluation of any nominees put forth under any proxy access bylaws that may be put in place at the company.

#### Director Education and Training

Typically, the nominating/corporate governance committee also is charged with the responsibility of overseeing the creation of director education and training programs.<sup>158</sup> As recommended by the Basel Committee, directors should be and remain qualified, including through training, for their positions.<sup>159</sup> Accordingly, directors should commit adequate time and effort to continuing training and education programs in order to stay abreast of the environment in which their banking organization operates, general industry trends and any statutory and regulatory developments pertinent to their organization. The FDIC Pocket Guide notes that such programs are particularly important in light of the fast-changing regulatory environment in which banking organizations operate and suggests that the board

consider creating formal director education seminars.<sup>160</sup> These programs need not be conducted exclusively or even principally by third parties; presentations to the board by members of management and other employees of the organization on important business, regulatory, compliance or other matters can be an excellent mechanism for director training because these presentations can focus on the specific institution and its issues (as opposed to more general education programs).

#### Qualifications of Members of Board Committees

In addition to setting the qualifications for directors, the nominating/corporate governance committee also should establish the qualification standards for the various committees of the board in light of the duties and functions of such committees. In doing so, the nominating/corporate governance committee should attempt to ensure that its parameters for qualifications of committee members comply with the requirements prescribed by statute, regulation and regulators for the particular committee (in particular, the audit and risk committees).

#### Board Evaluations and Oversight of Corporate Governance

In addition to the nominating/corporate governance committee’s traditional role of recommending candidates for directors, this committee increasingly has been charged with the task of developing corporate governance policies and practices for the banking organization.<sup>161</sup> Because director selection is so central to an organization’s corporate governance, it is common for the committee that is tasked with nominating directors also to be tasked with responsibility for board evaluations and oversight of the entity’s corporate governance generally, including responding to shareholder proposals under Exchange Act Rule 14a-8 and discussing with management any general changes or trends in governance procedures. As noted above, if these functions are performed by separate independent committees, the committees should coordinate as appropriate.

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<sup>155</sup> See OCC Director’s Book, at 4-5; Basel Principles, at 11.

<sup>156</sup> See ABA Guidebook, at 101 & 104.

<sup>157</sup> See SEC Release, Facilitating Shareholder Director Nominations, Rel. Nos. 33-9259, 34-65343 (September 15, 2011) (providing notice of effectiveness of the amendments to Rule 14a-8).

<sup>158</sup> See ABA Guidebook, at 104.

<sup>159</sup> Basel Principles, at 10; see also NYSE Manual, Section 303A.09 (requiring U.S. listed companies to address director education and training programs in their company governance guidelines).

<sup>160</sup> See also OCC Director’s Book, at 25-26 (noting that directors should stay informed of the banking organization’s operating environment and the availability of many resources such as training offered by industry organizations and guidance published by bank regulatory agencies); Basel Principles, at 10 (noting that directors should have access to programs of tailored initial and ongoing education on relevant issues and that directors should delegate sufficient time, budget and other resources for this purpose); OCC Guidelines, at 127 (requiring the boards of directors of certain large national banks to establish formal, ongoing training programs for all directors that include trainings on complex products and significant risks).

<sup>161</sup> See OCC Directors’ Book, at 34 (“Over time, the nominating committee’s function has been expanded to provide leadership in shaping a bank’s corporate governance practices by overseeing the composition, structure, compensation, and evaluation of the board and its committees.”); ABA Guidebook, at 102 & 104-05 (noting the committee’s expanded role in addressing corporate governance principles and practices).

The nominating/corporate governance committee should develop a system for “formal and rigorous evaluation” of the performance of the board and its committees.<sup>162</sup> These performance evaluations should be designed to gauge the effectiveness of the board and its committees and identify shortcomings that can be addressed by changing the size, composition or organizational structure of the board. The board and the audit, compensation and nominating/corporate governance committees of public companies generally are required to conduct annual performance evaluations pursuant to the rules of the national securities exchanges.<sup>163</sup> Any board evaluation process should be appropriately organized, conducted and documented to avoid creating a misleading, and potentially harmful, record. For example, the use of written questionnaires, if not properly managed, may create a record that does not accurately reflect the overall views of a director and could be taken out of context. As an alternative, boards and committees may want to structure the evaluation as an open discussion with individual directors of issues relating to board or committee performance, which ultimately is summarized in a brief written report.

#### Retirement Policy and Director Tenure

The evaluation of a banking organization’s director retirement policy also is generally under the purview of the nominating/corporate governance committee.<sup>164</sup> Some banking organizations provide that directors shall not be re-nominated upon reaching a certain age (e.g., 72 or 75), which may or may not be subject to waiver by the board or a committee. Banking organizations should determine, based on their own circumstances, whether a retirement age policy is appropriate and how any such policy is implemented. Any such policy, however, should not unduly limit the ability of the board to recruit or retain directors with the experience and attributes that the board desires as part of the overall mix of directors. Many boards that have set retirement ages have, from time to time in appropriate circumstances, determined that it was justifiable to waive the requirement or increase the retirement age in light of a desire to maintain the right mix of skill sets and experience on the board.

TCH does not believe that a banking organization should have term limits for individual directors—that is, limits on overall duration of service for individual directors – or specific requirements for average director tenure. The nominating/corporate governance committee should have the flexibility to determine whether a particular

director is continuing to contribute to the strength and diversity of the board or whether the board would benefit from the introduction of new directors in place of existing directors.<sup>165</sup> As the ABA has further noted, a “well-functioning nominating committee should be able to decline to nominate incumbents for reelection as individual situations dictate.”<sup>166</sup> Nominating/corporate governance committees should actively consider, in assessing director nominations and re-nominations, whether the board has the right mix of company-specific experience and new insight to function most effectively, and whether changes in the organization’s strategies, business, risk environment, technology or otherwise have created a need for a partial change in board constituency.

#### Section 8. Compensation Committees and Board Oversight of Executive Compensation

##### **Principles:**

- (a) The board of the top-tier entity within a banking organization should have a compensation committee, composed entirely of independent directors, to approve the compensation of the CEO and to oversee the compensation of other senior executives and the development of compensation programs that attract and retain highly qualified executives and other employees, satisfy regulatory standards and discourage inappropriate risk taking.**
- (b) The compensation committee should have an understanding of compensation practices in the financial services sector and should review and approve compensation practices that appropriately balance risk and reward (with input from the chief risk officer and the risk committee, as appropriate) and take into account compliance performance and ethical behavior.**

##### **Commentary:**

The compensation committee of the board typically is responsible for determining the compensation of the CEO and for determining (or making recommendations to the board with respect to) the compensation of other senior executives of the banking organization. The compensation committee also oversees the compensation and benefit programs for all the employees of the organization. Public companies generally are required to have a compensation committee composed entirely of independent directors

<sup>162</sup> Walker Review, at 16.

<sup>163</sup> See NYSE Manual, Section 303A; NASDAQ Rules, Section 5605. See also OCC Guidelines, at 128 (the boards of directors of certain large national banks should perform annual self-assessments that include evaluations of their effectiveness in meeting the standards in the OCC Guidelines).

<sup>164</sup> See ABA Guidebook, at 105.

<sup>165</sup> See Organisation for Economic Co-operation and Development, Corporate Governance Factbook (2014), at 36 (noting that only a small minority of jurisdictions deem the tenure of a public company director to impact independence).

<sup>166</sup> *Id.* at 100.

pursuant to rules adopted by the national securities exchanges.<sup>167</sup>

In the aftermath of the financial crisis of 2008, the compensation policies of banking organizations became a subject of focus among regulators and commentators. In June 2010, U.S. federal bank regulators issued the Guidance on Sound Incentive Compensation Policies<sup>168</sup> (“[Joint Guidance on Compensation](#)”), which outlines principles aimed at ensuring that incentive compensation policies of banking organizations do not undermine their safety and soundness by encouraging employees to take imprudent risks and stresses the role of the board in overseeing the development and implementation of, and compliance with, these principles.<sup>169</sup> Broadly speaking, the Joint Guidance on Compensation requires incentive compensation arrangements at banking organizations (i) to provide employees with incentives that appropriately balance risk and reward, (ii) to establish and comply with effective controls and risk management practices, and (iii) to be supported by strong corporate governance, including active and effective oversight by the organization’s board.<sup>170</sup> Specifically, the Joint Guidance on Compensation provides that a banking organization’s board or its compensation committee should review and approve key elements of the organization’s incentive compensation system, receive and review periodic evaluations of the organization’s compensation system and directly approve the incentive compensation arrangements for senior executives.<sup>171</sup> The Joint Guidance on Compensation also provides that the board or its compensation committee should “have, or have access to, a level of expertise and experience in risk management and compensation practices in the financial services sector that is appropriate for the nature, scope and complexity of the organization’s activities.”<sup>172</sup>

#### Section 956 of the Dodd-Frank Act imposes additional oversight responsibilities with respect to compensation

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<sup>167</sup> See NYSE Manual, Section 303A.05; NASDAQ Rules, Sections 5605(d)(2) (A).

<sup>168</sup> 75 Fed. Reg. 36,396 (June 25, 2010).

<sup>169</sup> See Joint Guidance on Compensation, at 36,396.

<sup>170</sup> See *id.* at 36,398. See also OCC Guidelines, at 215 & 126 (certain large national banks are required to establish a compensation and performance management program that, among other things, prohibits “incentive-based payment arrangements, or any feature of any such arrangement, that encourages inappropriate risks by providing excessive compensation or that could lead to material financial loss”).

<sup>171</sup> See Joint Guidance on Compensation, at 36,412.

<sup>172</sup> *Id.* at 36,402. See also Walker Review, at 118-19 (noting that risk adjustment in remuneration structure is essential to counterbalance any executive disposition to increase risk as the means of increasing short-term returns, and suggesting that the remuneration committee should seek advice from the risk committee on specific risk adjustments to be applied to performance objectives set in the context of incentive packages).

policies on the compensation committees and boards of banking organizations that have consolidated assets of \$1 billion or more. Under the rules proposed by federal bank regulators under the Dodd-Frank Act, the board or the compensation committee of these banking organizations would be required to approve policies and procedures regarding compensation arrangements and attempt to ensure that such arrangements effectively balance the financial rewards to employees with the risks associated with their activities and reduce incentives for inappropriate risk taking.<sup>173</sup> The proposed rules set forth standards, including those relating to board and compensation committee oversight, that generally are consistent with, and in certain aspects more prescriptive than, the principles in the Joint Guidance on Compensation.<sup>174</sup> The proposed rules provide that the board or its compensation committee must actively oversee the development and operation of the institution’s incentive-based compensation systems and related control processes, review and approve the overall goals and purposes of that compensation system in light of the institution’s overall risk tolerance, and receive data and analysis to assess the overall design and performance of the incentive compensation arrangements.<sup>175</sup>

Consistent with Section 952 of the Dodd-Frank Act and Rule 10C-1,<sup>176</sup> both the NYSE and NASDAQ have adopted rules to subject compensation committee members to enhanced independence standards. Specifically, in determining whether a director is “independent” for purposes of participation in the compensation committee, the board of directors must consider, in addition to the general independence standards, “all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director’s ability to be independent from management in connection with the duties of a compensation committee member,” including (i) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the listed company to such director and (ii) whether such director is affiliated with the listed company or any of its subsidiaries or their affiliates.<sup>177</sup> The NYSE and NASDAQ rules also provide that the compensation committee may, in its sole discretion, retain a compensation adviser, and require that the compensation committee consider

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<sup>173</sup> See FDIC, OCC, Federal Reserve Board, Office of Thrift Supervision, National Credit Union Administration, SEC, Federal Housing Finance Agency, Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170, 21,173 (April 14, 2011) (“[Incentive-Based Compensation Arrangements](#)”).

<sup>174</sup> *Id.* at 21,173.

<sup>175</sup> *Id.* at 21,180.

<sup>176</sup> See 17 C.F.R. § 240.10C-1.

<sup>177</sup> NYSE Manual, Sections 303A.05(a) & 303A.02(a)(ii); NASDAQ Rules, Section 5605(d)(3).

certain independence criteria prior to hiring the adviser.<sup>178</sup> Under SEC rules, listed companies also are required to disclose retention of compensation consultants and conflicts with compensation consultants.<sup>179</sup> However, there is no requirement that the compensation committee retain compensation consultants, and each banking organization's compensation committee should determine whether and when a consultant is appropriate in light of the individual organization's circumstances.

Bank regulatory guidance places particular emphasis on the relationship between compensation and risk taking. As the Basel Committee recommends, the compensation in banking organizations "should be effectively aligned with prudent risk taking."<sup>180</sup> More generally, the OCC advises that the compensation committee should consider the following factors in determining the compensation and benefits packages for officers and employees:

- (i) combined value of all cash and noncash benefits provided to the individual;
- (ii) compensation history of the individual and other individuals with comparable expertise at the bank;
- (iii) the bank's financial condition;
- (iv) comparable compensation practices at similar institutions, based on such factors as asset size, geographic location and complexity of business activities;
- (v) projected total cost and benefit to the bank for post-employment benefits; and
- (vi) any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the bank.<sup>181</sup>

Regulators also are increasingly focusing on the process of determining compensation for staff engaged in financial and risk control (including audit, risk management and compliance). For instance, the FSB advises that staff engaged in financial and risk control should be compensated in a manner that is independent of the business areas they oversee.<sup>182</sup> In particular, the FSB Principles indicate that risk control employees play an

important role in preserving the integrity of the financial and risk management, and hence their compensation should not be influenced by personnel in front line business areas.<sup>183</sup> In addition, the compensation of risk control employees should not be so affected by short-term performance measures such that their independence will be compromised.<sup>184</sup> More informally, U.S. regulators are emphasizing that absolute and relative compensation of staff in these areas should be sufficient to attract and retain qualified personnel. The Federal Reserve Enhanced Standards require bank holding companies with total consolidated assets of \$50 billion or more to appoint a chief risk officer, and the compensation of the chief risk officer should be appropriately structured to provide for an objective assessment of the risks taken by the bank holding company.<sup>185</sup>

TCH believes that the top-tier entity within a banking organization should have a compensation committee composed entirely of independent directors to approve CEO compensation, to approve (or make recommendations to the board with respect to) the compensation of other senior executives, and to oversee development and implementation of, and compliance with, compensation programs that satisfy regulatory standards and safeguard against inappropriate risk taking. These top-tier compensation committees should have access to financial, legal and risk management experts, which may be internal or external as the committees may determine, to enable them to monitor and implement the developing regulatory requirements in this area. The interaction between the boards of the holding company and the bank in making compensation decisions (including whether the bank itself should have a compensation committee and what role the bank board should have in the overall compensation process in order to protect the safety and soundness of the bank) will, subject to any applicable statutory requirements,<sup>186</sup> depend on the overall structure of the banking organization and will likely vary from organization to organization.

178 NYSE Manual, Sections 303A.05(c); NASDAQ Rules, Section 5605(d)(2)(A). The compensation committee is not required to assess independence in the case of a compensation adviser that merely consults on broad-based plans or provides non-customized or issuer-specified information. *Id.*

179 See Item 407(e)(3)(iii) & (iv) of Regulation S-K.

180 Basel Principles, at 26; see also OCC Director's Book, at 32-33 and Joint Guidance on Compensation, at 36,398.

181 OCC Director's Book, at 33.

182 See FSB, Principles for Sound Compensation Practices (April 2, 2009) ("FSB Principles"), at 7.

183 *Id.*

184 *Id.*

185 See Federal Reserve Enhanced Standards, § 252.33(b)(3)(i). See Section 4 for a further discussion of the chief risk officer requirement under the Federal Reserve Enhanced Standards.

186 See, e.g., OCC Guidelines, at 113 & 114 (the boards of directors or board committees of certain large national banks are required to approve the annual compensation and salary adjustment of the chief risk and chief audit executive).

**Principles:**

- (a) The board of the top-tier entity within a banking organization should have a committee to monitor its risk management systems and control procedures for identifying, assessing and managing its risk exposures.**
- (b) This committee should include at least one member with substantial risk management knowledge and experience.**

**Commentary:**

In recent years, bank regulators have increasingly emphasized the importance of risk management within banking organizations and the role of the board of directors in that process. For instance, the Basel Committee states, “[r]isks should be identified and monitored on an ongoing firm-wide and individual entity basis, and the sophistication of the bank’s risk management and internal control infrastructures should keep pace with any changes to the bank’s risk profile (including its growth), and to the external risk landscape.”<sup>187</sup> Similarly, the OCC states that a banking organization’s “safety and soundness are contingent upon effectively managing its risk exposures.”<sup>188</sup> According to the OCC, a risk committee with broad responsibility for overseeing all of the bank’s risk management activities can promote “an integrated approach to evaluating and monitoring interrelated risks, especially in banks with complex activity and product mixes.”<sup>189</sup> Some commentators caution, however, that the creation and role of a risk committee should not “take the place of the ultimate responsibility and accountability of the whole board for the governance of risk.”<sup>190</sup>

The Dodd-Frank Act also imposed additional risk management responsibility on the board of directors. As directed by Section 165(h) of the Dodd-Frank Act, the Federal Reserve Board has finalized regulations requiring bank holding companies with total consolidated assets of \$50 billion or more and publicly traded bank holding companies with total consolidated assets of \$10 billion or more to establish a risk committee that approves and periodically reviews the enterprise-wide risk management policies and oversees the company’s enterprise-wide risk management framework.<sup>191</sup> The risk committee for bank holding companies with total consolidated assets of \$50 billion or more also is subject to the liquidity risk

management requirements.<sup>192</sup> Under the Federal Reserve Enhanced Standards, the risk committee is required to be chaired by an independent director<sup>193</sup>, and the Federal Reserve Board encourages companies to include additional independent directors on the committee.<sup>194</sup> The Federal Reserve Enhanced Standards do not, however, require that the committee be composed solely of independent directors, and some banking organizations may determine that it is appropriate to include in the committee a member of management with the risk management expertise as required by the Federal Reserve Enhanced Standards.

The risk committee is required to include at least one member with “risk management expertise” commensurate with the company’s structure, risk profile, complexity, activities, size and other appropriate risk-related factors.<sup>195</sup> For bank holding companies with total consolidated assets of \$50 billion or more, “risk management expertise” means “experience in identifying, assessing, and managing risk exposures of large, complex financial firms” (similar to the definition for purpose of the chief risk officer as described in Section 4 of these Governance Principles). For organizations not covered by this specific regulatory mandate, the board might conclude that experience with a suitably complex non-financial firm provides an appropriate level of risk management expertise for purposes of the risk committee’s functions. In addition, in the preamble to the final rule, the Federal Reserve Board expresses its further expectation that all members of the committee generally should have an understanding of risk management principles and practices relevant to the company.<sup>196</sup>

As a general governance matter, TCH believes that, subject to any relevant regulatory constraints, it should be acceptable, and the board may determine that it is preferable, for the audit and risk functions to be combined into a single committee if the focus and effectiveness of the committee are not undermined and the members meet all relevant independence and qualification criteria. Similarly, the board may determine that elements of risk oversight relating to particular areas, such as technology, compliance, reputation, compensation, corporate responsibility, financing or credit exposures, among others, are best housed within committees that focus on these areas, so long as the overall board structure provides for appropriate enterprise-wide risk oversight.

It should be noted, however, that the Federal Reserve Enhanced Standards will not permit bank holding

187 Basel Principles, at 19.

188 OCC Director’s Book, at 10.

189 *Id.* at 31 & 32.

190 Walker Review, at 90.

191 See Federal Reserve Enhanced Standards, §§ 252.22(a) & 252.33(a).

192 *Id.* § 252.34.

193 *Id.* §§ 252.22(d)(2) & 252.33(a)(4).

194 *Id.* at 36.

195 *Id.* §§ 252.22(b) & 252.33(a)(2).

196 *Id.* at 38.

companies with total consolidated assets of \$50 billion or more to combine their risk committees with any other committees.<sup>197</sup> For large bank holding companies that are required to maintain a standalone risk committee, there should be appropriate coordination among board committees, possibly including joint members or periodic joint meetings as appropriate, so that the company's financial reporting, internal control, risk management and other relevant areas are considered together. The Federal Reserve Board specifically noted in the preamble to the Federal Reserve Enhanced Standards that it is acceptable for a risk committee to have members that are on other board committees, and that other board committees may be involved in establishing the company's risk management framework.<sup>198</sup> In fact, NYSE rules require the audit committee of a listed company to maintain some oversight over the company's risk management.<sup>199</sup>

In addition to the Dodd-Frank Act requirements, regulations promulgated by the SEC contain a number of disclosure requirements that touch upon risk and thus require a public company, including a public banking organization, to evaluate and describe its risk structure. A public company must disclose in its annual proxy statement its policies and practices of compensating its employees and management as they relate to the risk profile of the organization if the risks arising from these compensation policies are reasonably likely to have a material adverse effect on the organization.<sup>200</sup> Public companies also are required to disclose the extent of the board's role in risk oversight.<sup>201</sup> Thus, in light of the interrelation between compensation policy and risk management, the risk and compensation committees should appropriately coordinate efforts so that the

compensation programs satisfy regulatory standards and do not encourage inappropriate risk taking.<sup>202</sup>

## Section 10. Funding and Authority to Engage Advisors

### **Principles:**

**The board and each committee of the board should have the authority to engage counsel and outside advisors as it deems necessary to carry out its duties, and should be able to call upon the banking organization for appropriate funding to compensate such counsel and advisors and to pay other administrative expenses.**

### **Commentary:**

The board and each standing committee of the board should have the authority to retain their own legal counsel and professional advisors when they determine such direct advice is desirable.<sup>203</sup> This authority necessarily should be supported by appropriate funding by the banking organization in order to compensate such counsel and advisors and to pay other administrative expenses. The Sarbanes-Oxley Act and the rules promulgated by the SEC pursuant thereto grant the audit committee of a public company the authority to engage counsel and other advisors and require the company to pay for these advisors.<sup>204</sup> Securities exchange listing standards provide similar authority for the compensation and nominating/corporate governance committees.<sup>205</sup>

In particular, advisors can serve as valuable resources when the board or committee is considering complex or specialized issues that require expert knowledge. Directors of banking organizations, like those of other corporate entities, are entitled to rely in good faith on reports, opinions, information and statements (including financial statements and other financial data) prepared by outside experts, such as legal counsel and public accountants, whom the directors reasonably believe to be reliable and competent.<sup>206</sup> In certain circumstances, particularly

<sup>197</sup> *Id.* § 252.33(a)(3).

<sup>198</sup> See Federal Reserve Enhanced Standards, at 42. The preamble to the Federal Reserve Enhanced Standards also states that the rule does not prevent a parent company's risk committee from serving as the risk committee for one or more of its subsidiaries as long as the requirements of the rule are otherwise satisfied. The board may determine that the risk committee maintain oversight relating to any or all particular categories of risk (in addition to or as part of its enterprise-wide risk management responsibilities), subject to any relevant legal constraints.

<sup>199</sup> See NYSE Manual, Section 303A.07(b)(iii)(D).

<sup>200</sup> See Item 402(s) of Regulation S-K.

<sup>201</sup> See Item 407(h) of Regulation S-K. In a June 2014 speech, SEC Commissioner Luis Aguilar referenced the 2009 adoption of these rules as part of the SEC's efforts to highlight the importance of the board's risk oversight role. In the context of cybersecurity risks, Commissioner Aguilar stated that boards have "begun to assume greater responsibility for overseeing the risk management efforts of their companies." Speech by Commissioner Luis A. Aguilar at the NYSE "Cyber Risks and the Boardroom" Conference (June 10, 2014).

<sup>202</sup> See Basel Principles, at 25 (suggesting that the compensation committee work closely with the risk committee to evaluate incentives arising from compensation and undertake an annual compensation review); see also Federal Reserve Enhanced Standards, § 252.33(a) (requiring the risk committee to oversee the operation of an enterprise-wide risk management framework, including integration of risk management and control objectives in management goals and the company's compensation structure).

<sup>203</sup> See ABA Guidebook, at 48-50.

<sup>204</sup> See Sarbanes-Oxley Act, § 301, Exchange Act Rule 10A-3(b)(4) & (5); see also NYSE Manual, Section 303A.07(b)(iii) and NASDAQ Rules, Section 5605(c)(3).

<sup>205</sup> See NYSE Manual, Sections 303A.04 and 303A.05; NASDAQ Rules, Sections 5605(d).

<sup>206</sup> See, e.g., 8 Del. C. § 141(e); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); *Prince v. Bensinger*, 244 A.2d 89, 94 (Del. Ch. 1968).

with regard to sensitive matters such as reviewing and approving compensation packages for senior executives or discussing an external auditor's concerns regarding the organization's control procedures, the board or a committee may wish to engage counsel and/or advisors that do not advise the banking organization on such matters or that have little or no relationship with the organization in any other respect. The determination of the degree of independence required is a function of all the relevant facts and circumstances.<sup>207</sup>

#### Section 11. Independent Leadership of the Board

##### **Principles:**

**The board should determine its own form of independent leadership. If the board determines that the CEO or another non-independent director should serve as chairperson, the independent directors of the board should designate, among themselves, a lead independent director. The lead director should generally have authority to:**

- (a) approve the agenda and schedule for each board meeting and the information to be provided to the board (board materials and board presentations); and**
- (b) convene and chair regular and special executive sessions of the board (i.e., sessions where no member of management, including the CEO, is present).**

##### **Commentary:**

The chairperson of the board plays a crucial role in the functioning of the board. The chairperson provides leadership to the board and aids the board in functioning effectively and meeting its obligations and responsibilities.<sup>208</sup> As the Basel Committee further explains, "The chair should ensure that board decisions are taken on a sound and well-informed basis. He or she should encourage and promote critical discussion and ensure that dissenting views can be expressed and discussed within the decision-making process."<sup>209</sup>

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<sup>207</sup> See NYSE Manual, Sections 303A.05(c) and NASDAQ Rules, Section 5605(d)(2)(A) (requiring the compensation committee to consider certain independence criteria prior to hiring a compensation adviser, except for a compensation adviser that merely consults on broad-based plans or provides non-customized or issuer-specified information). These requirements are discussed further in Section 8.

<sup>208</sup> See Basel Principles, at 12.

<sup>209</sup> *Id.*

In the United States, it is common for the CEO of a corporate entity also to serve as the chairperson.<sup>210</sup> The ABA notes, however, that in a growing number of public companies, the two functions are separated.<sup>211</sup> It has been suggested that separation helps to establish appropriate "checks and balances" between the board and management.<sup>212</sup> On the other hand, many organizations have determined that separation can cause inefficiencies, and even friction, between the board and management, and that there are significant benefits to having the CEO, who is closest to the day-to-day operations and risk environment, initially formulating the board agenda, with appropriate independent director input and feedback. While it is somewhat more common in certain non-U.S. jurisdictions to have an independent chairperson, most jurisdictions still allow companies to decide for themselves whether to have an independent chairperson, recognizing that there is no universal "right answer" to such question.<sup>213</sup> Board leadership structures have evolved over time, and it is the view of the TCH that it would be a mistake for overly prescriptive regulation to impede this process of evolution by limiting flexibility.

The board of a banking organization should determine whether its CEO should be the chairperson of the board based on its unique circumstances and needs. For example, the board of a banking organization may determine that its CEO should serve as the chair because of his or her leadership abilities and other qualifications. Conversely, the board of another banking organization may select an independent director to serve as the chair because of his or her knowledge, experience and reputation. Thus, banking organizations may choose to separate or combine the positions of CEO and chairperson for a variety of reasons, and there can be no single prescription that serves all banking organizations.<sup>214</sup> A public company is required to disclose in its annual proxy statement the reasons why it has chosen the same or different people to serve in the positions of chairperson and CEO. Furthermore, if the same person serves as both CEO and chairperson, the company must disclose whether

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<sup>210</sup> See ABA Guidebook, at 46 ("For many public companies in the United States, the CEO of the corporation also serves as chair of the board."); NACD Key Agreed Principles, at 8 (noting that "some form of independent leadership is required, either in the form of an independent chairman or a designated lead or presiding director").

<sup>211</sup> ABA Guidebook, at 46.

<sup>212</sup> Basel Principles, at 12.

<sup>213</sup> See Organisation for Economic Co-operation and Development, Corporate Governance Factbook (2014), at 30 (noting that only a minority of jurisdictions incentivize, recommend or require separation of chairperson and CEO roles at public companies, and only 10% require it).

<sup>214</sup> See ABA Guidebook, at 46 (noting that there is no one-size-fits-all prescription and that the board should thus decide what works best for its organization).

it has a lead independent director and what specific roles the lead director plays in the leadership of the board.<sup>215</sup>

If the board determines that it is advisable to combine the positions of CEO and chairperson, or to otherwise appoint a non-independent director as the chairperson, then, as a matter of good corporate governance, TCH believes that, absent a compelling reason to the contrary, the independent directors of the board should designate, among themselves, a lead independent director.<sup>216</sup> The lead director should work with the CEO to approve the agenda and schedule for each board meeting and to review the types of information to be distributed to the board and its committees for their consideration.<sup>217</sup> He or she also may be called upon by the board or by senior management to meet with shareholders or shareholder groups that wish to convey concerns to the board. If such meetings are held, the full board should be promptly informed of such communications.<sup>218</sup> The lead director should be available to serve as the board's liaison to the CEO and facilitate communication between them.<sup>219</sup>

The lead director will ordinarily be charged with the duty to chair executive sessions of the board. Executive sessions are meetings attended solely by independent directors and are designed to allow for open discussion of management issues without the presence of management directors.<sup>220</sup> In the United States, listed companies are required to hold executive sessions of independent directors on a regularly scheduled basis.<sup>221</sup> The use of executive sessions by the board is advisable, as executive sessions can provide a forum for independent directors to bring up ideas or raise issues that they may otherwise be reluctant to raise in front of the non-independent directors and to share candid views about management's performance and board operations.<sup>222</sup>

215 See Regulation S-K, Item 407(h).

216 See ABA Guidebook, at 46 (noting that, when a non-independent director or the CEO serves as the chairperson, the independent directors often designate, among themselves, a director to act as a lead director).

217 *Id.*; see also Institutional Shareholder Services Inc., 2014 U.S. Proxy Guidelines Summary (December 19, 2013) ("U.S. Proxy Guidelines Summary"), at 20.

218 See ABA Guidebook, at 46.

219 *Id.*; see also U.S. Proxy Guidelines Summary, at 20.

220 Under the NYSE rules, the executive sessions also may include non-independent directors who are not members of management, so long as the independent directors meet at least annually in executive session with no non-independent directors present. NYSE Manual, Section 303A.03.

221 See, e.g., NYSE Manual, Section 303A.03 and NASDAQ Rules, Section 5605(b)(2).

222 See ABA Guidebook, at 50.

## Section 12. Agenda, Materials and Length of Meetings

### **Principles:**

- (a) The agenda for each board and committee meeting should list the subjects that are expected to be discussed at the meeting.**
- (b) Although board and committee meetings generally should follow the agenda, some flexibility may be necessary or appropriate to discuss matters that, because of the time at which they arose or for other reasons, are not listed on the agenda.**
- (c) Materials for board and committee meetings (including the agenda) should be provided to directors sufficiently in advance of meetings, and should contain sufficient detail to enable the directors to prepare appropriately. It is recognized, however, that circumstances may necessitate shortening this time period on occasion. Directors are expected to have read board and committee materials that were provided in advance.**
- (d) Board meetings should include presentations by senior management, other employees of the company and advisors, as appropriate, covering major business, financial performance, risk and control, and legal and compliance matters. Committee meetings should include presentations tailored to the needs of the committee from time to time. Significant time should be reserved for board and committee discussions.**
- (e) Directors should devote sufficient time in a meeting to address all agenda subjects and such other subjects as may be brought to their attention.**

### **Commentary:**

#### Agenda

The agenda for each board or committee meeting generally dictates what the directors will discuss at the meeting and should therefore list each subject that is to be considered at the meeting. The duty of setting the agenda for board meetings typically is delegated to the CEO and the chairperson (or the lead director, if the chairperson is not independent), with the chairperson having the primary responsibility and coordinating with the other as appropriate.<sup>223</sup> In general, the agenda should be designed to address the significant issues and transactions of the organization, and generally should not include other, less important subjects, as this may detract the board from

223 See ABA Guidebook, at 47.

devoting time to the important matters.<sup>224</sup> Therefore, in formulating the agenda, the chairperson should consider whether a particular issue or transaction is important enough to merit board action or attention. In addition, any individual director should be able to request that the chairperson include a subject on the agenda.<sup>225</sup> In this regard, banking organizations may consider establishing a formal system for gathering feedback and views regarding potential agenda subjects from individual directors.

Although the agenda normally controls the flow and the content of the meeting, the board or committee nonetheless can address matters not on the agenda if circumstances so warrant. For example, it may be necessary or appropriate for the board or committee to discuss a matter that may have a significant impact on the banking organization even though it arises only after the agenda for the meeting already has been established and is, therefore, absent from the agenda.

Furthermore, the organization should consider preparing an annual agenda that includes matters requiring recurring and focused attention, such as periodic review of the banking organization's financial and operational plans, risk management, evaluation of the performance of the management, board and committees, legal and compliance matters and the adequacy and appropriateness of corporate systems and controls.<sup>226</sup> Subject to applicable regulatory requirements, the board should have flexibility in determining the issues addressed at meetings and the items that will require board or committee review or approval. The board should, in one form or another, articulate an approach for determining what matters should be addressed at the board and committee level, so that individual board members and senior management are aware of, and operate consistently with, the board's expectations.

#### Materials for Meetings

Comprehensive and quality information is critical for the board or committee to function effectively, and for the directors to meet their duty of care. As the ABA notes, the quality of the information made available to directors will significantly affect their ability to perform their roles effectively.<sup>227</sup> Accordingly, materials for a board or committee meeting should contain material and accurate information regarding all the subjects on the agenda but should not be so voluminous that they detract from effective discussion and deliberation during meetings. Thus, meeting materials ordinarily should consist of written reports from management as well as

summaries of the organization's issues and transactions that are drafted by the employees of the organization or outside professionals. As mentioned in Section 10 of these Governance Principles, directors are entitled to rely in good faith on summary reports, opinions, information and statements prepared by the organization's officers and employees, legal counsel and public accountants whom they reasonably believe to be reliable and competent.<sup>228</sup>

Meeting materials should be furnished to the directors sufficiently in advance of the meeting to allow time for careful study and thoughtful reflection, and to give directors a basis to challenge management's assumptions and recommendations, as appropriate.<sup>229</sup> It is recognized, however, that some circumstances may necessitate the preparation and distribution of materials to directors at short notice. Furthermore, it may be necessary and appropriate for certain sensitive information to be presented orally at a board or committee meeting, rather than being included in the materials.

When faced with a claim of a breach of duty of care by a director, courts frequently look to the adequacy of information provided to the director and the length of time the director was permitted to review such information.<sup>230</sup> Consequently, it is important, especially in the case of significant corporate transactions, other significant decisions or significant oversight issues, to provide directors with materials a sufficient amount of time in advance of the meeting. Directors in turn should review such materials carefully before the meeting to make certain that they are able to participate meaningfully and actively in the deliberative process.<sup>231</sup>

Regular attendance and active participation at board and committee meetings is a fundamental expectation that a banking organization will have of its directors. Consistent with the SEC disclosure requirements in Item 407(b) of Regulation S-K, TCH believes that each director of a banking organization should attend at least 75% of the meetings of the board and any applicable committees in any given year and should strive to attend all of them.

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228 See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); *Prince v. Bensinger*, 244 A.2d 89, 94 (Del. Ch. 1968).

229 See ABA Guidebook, at 48; see also OCC Director's Book, at 71 (suggesting that the directors should receive the meeting materials early enough to review the information carefully before the meeting because the board functions at its best when informed directors interact and apply their expertise).

230 See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872-75 (Del. 1985) (citing the failure of the directors to obtain adequate information prior to taking action as a breach of their duty of care); *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) (noting that a lack of due care by the directors may be evidenced by showing the use of a "grossly negligent process" that includes the failure to consider all material facts reasonably available).

231 See ABA Guidebook, at 20.

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224 See Martin Lowy, *Corporate Governance for Public Company Directors* (2003), at 78.

225 See ABA Guidebook, at 47.

226 See *id.* at 47-48.

227 *Id.* at 48.

## Presentations by Management

Some commentators maintain that the asymmetry in the amount of information available to management directors and non-management directors is one of the biggest barriers to conducting effective board meetings.<sup>232</sup> To correct such asymmetry, the board should consider inviting senior executive officers and other relevant employees on a regular basis to present information regarding key aspects of the organization's business, recent changes in regulations and such other matters as the board deems appropriate. A live presentation often can be more engaging than written summaries and reports and also enables directors to ask questions and have a more meaningful discussion with the organization's management. At the discretion of the chairperson (or lead director, if the chairperson is not independent), a presentation may be made in executive session. In determining whether a subject should be presented in executive session, the chairperson or lead director should consider whether to consult with legal counsel and other outside experts as appropriate.

## Length of Board Meetings

There is no prescribed length for board or committee meetings. On the one hand, meetings that are too brief can prevent the board or committee from effectively fulfilling its oversight responsibility and may adversely impact the banking organization's strategies and performance. On the other hand, prolonged meetings can lead directors to lose track of the important issues at hand and can detract from a meaningful consideration of crucial matters. As a practical matter, the length of meetings will tend to correlate with the quantity and significance of the subjects on the agenda. Nonetheless, directors should devote sufficient time to address each subject on the agenda fully and satisfactorily and also consider other subjects that may be brought to their attention.

### Section 13. Minutes of Board Meetings

#### **Principles:**

- (a) **The minutes of meetings of the board and its committees should be kept in accordance with the applicable corporate statute under which the banking organization is organized. The board should decide on the level of detail that it believes is appropriate for the minutes, balancing the need to maintain an adequate record to satisfy legal requirements and the need to avoid chilling discussion among directors. Although minutes may prove to be useful for bank regulator examiners reviewing corporate decision making, they are not designed for that purpose.**

- (b) **It is common practice not to create detailed minutes of executive sessions of independent directors, because doing so would be antithetical to the very objective of such sessions. The subject matter of such sessions and any formal actions taken may be noted in the minutes, as appropriate.**

#### **Commentary:**

Boards of banking organizations and their committees generally are required by state corporate statutes to keep minutes of their proceedings.<sup>233</sup> Minutes of meetings of the board and its committees constitute an important part of a corporation's books and records. Among other matters, minutes serve as the most fundamental record of the board and its committees' actions and serve as an important corporate record of the discharge by directors and committee members of their fiduciary and other duties.

It is generally recognized that there is variation among corporate entities with respect to the level of detail presented in minutes. There is no single, correct approach to recording minutes, and the board should decide upon an approach based on its circumstances and needs. Nonetheless, TCH believes that both extremes should be avoided. The minutes should not be a verbatim transcript of the meeting and, in particular, should not attribute specific views to particular directors in a way that could chill discussion. But the minutes should cover, at a minimum, a description of significant subjects discussed, the nature of the discussions, decisions reached and any dissenting votes or abstentions. Bank regulators have indicated that board and committee minutes should constitute an accurate, adequate record of actions taken and should document the board's review of regular subjects (including review of the entity's financial condition and earnings, loan activity, investment portfolio, policies and procedures and audit and examination reports) as well as any other significant subjects discussed at a particular meeting.<sup>234</sup>

The Federal Reserve Board further advises that, at a minimum, the minutes should "record the attendance or absence of each director at each meeting, detail the establishment and composition of any committees, and note the abstention of any director from any vote."<sup>235</sup> Similarly, the OCC notes that, if a director disagrees with a board action, the director should formally state his or her view, explain the reasons for disagreement and request

<sup>233</sup> See, e.g., 8 Del. C. § 142(a) (requiring corporations to appoint an officer to record the proceedings of the meetings of the board); see also N.Y. Bus. Corp. § 624(a) (requiring corporations to keep minutes of the proceedings of its shareholders, board and executive committee, if any).

<sup>234</sup> See Commercial Bank Manual, Section 5000.1, at 4.

<sup>235</sup> *Id.*

<sup>232</sup> See, e.g., Colley–Governance, at 83.

that the position be recorded in the minutes.<sup>236</sup> These prescriptions regarding the minutes of board meetings apply equally to meetings of its various committees.<sup>237</sup>

In terms of procedures, minutes should be drafted by an authorized officer of the banking organization and circulated to the directors promptly following the meeting. If possible, the minutes should be presented for approval at the next regular meeting of the board or committee. Draft minutes should be included in the package of materials distributed prior to the meeting at which approval of the minutes will be sought. Although directors may wish to take personal notes to assist the discussion process, to identify immediate follow-up subjects and to support their review of the minutes, they need not retain any meeting notes after reviewing and approving the formal minutes of that meeting unless otherwise required by law.<sup>238</sup> Once minutes have been approved by the board or a committee, they should not be altered without being resubmitted for approval.

Minutes invariably are reviewed as part of regulatory examinations and often are required to be produced in connection with litigation and governmental investigations and as part of the annual audit of a corporation's financial statements.<sup>239</sup> In addition, minutes also must be available for inspection by the directors and, in certain cases, shareholders may be entitled to demand access to them.<sup>240</sup>

The decision-making process at the board level should be an interactive one, with presentations, questions and discussion. TCH believes that it would be inimical to a board's effectiveness, through a chilling effect on discussions at board meetings, if the minutes basically transcribed all questions and points of view expressed during the meeting. A regulator could obtain a broader understanding of board challenge that occurs during or outside of board meetings by addressing the topic during the director interactions with regulators described in Section 15.

As discussed above, as a matter of good corporate governance, directors should meet in regularly scheduled executive sessions at which management is not present. Executive sessions are intended to serve as a venue for open dialogue at which the directors can freely discuss

issues among themselves. Requiring detailed minutes of executive sessions would be antithetical to the very objective of such sessions. It is therefore a common practice not to create detailed minutes of executive sessions; the ABA notes that "simple minutes that set forth the attendees at the executive sessions and generally list the topics discussed and recommended actions will normally suffice."<sup>241</sup>

#### Section 14. Board Compensation

##### **Principles:**

**The board should adopt a compensation structure for the non-management directors, committee members and the individual directors with designated responsibilities (e.g., lead director and committee chairs) so that the most qualified individuals can be attracted and retained and the interests of directors and shareholders can be aligned, as appropriate.**

##### **Commentary:**

The board of a banking organization should determine the compensation of the directors and committee members based on an assessment of the compensation policies of peer organizations (*i.e.*, other banking organizations of similar size with similar businesses and operations), an analysis of any special factors that are unique to the organization and the qualifications and expertise of the individual directors. Due to the inherent conflict of interest in the board setting its own compensation, the board should use external benchmarks, such as comparisons to peer organizations and independent compensation consultants, as appropriate.<sup>242</sup>

Typically, the nominating/corporate governance committee or compensation committee of the board is charged with evaluating the form and amount of director compensation, subject in some cases to approval by the full board. In evaluating director compensation, the committee should consider the factors mentioned above as well as the time commitment and responsibility of the lead director, individual committee members and chairs. For instance, the chair of the audit, risk or other key committees and other members of such committees are charged with significant and time-consuming responsibilities, and, therefore, the level of compensation

236 See OCC Director's Book, at 73.

237 Commercial Bank Manual, Section 5000.1, at 5 (noting that committees should keep minutes that meet the same standards used for minutes of meetings of the full board).

238 See ABA Guidebook, at 53 (noting that directors have no obligation to take notes).

239 See, e.g., Commercial Bank Manual, Section 5000.3, at 2-3 (noting that examiners should obtain minutes of the meetings of the board during an examination).

240 See, e.g., 8 Del. C. § 220(b).

241 See ABA Guidebook, at 51.

242 See, e.g., ABA Guidebook, at 106 (noting that boards should make sure they have "considered the information necessary to reach a fair decision" regarding director compensation, including "data on peer companies and an analysis of any factors relating to their particular circumstance, such as the complexity of the company and the expected time commitment").

for directors who serve in such positions typically is higher.<sup>243</sup>

The committee tasked with evaluating board compensation also should have flexibility in determining the form of director compensation. The committee may decide to set director compensation in the form of annual retainers or attendance fees for meetings and make payments in stock, cash, stock options or restricted stock grants. In determining the form of payment, the committee should consider the benefit of aligning the interests of the directors with the long-term interests of the banking organization.<sup>244</sup> As the ABA notes, compensation in the form of stock options and restricted stock grants can “strengthen the directors’ interest in the overall success of the corporation and better align their personal interests with those of shareholders.”<sup>245</sup> In addition, the board of banking organizations may consider requiring directors to purchase a minimum amount of stock in the open market or to accept at least a designated portion of their compensation in stock grants rather than cash. Ordinarily, management directors do not receive compensation for serving on the board.

The increasing complexities of the banking industry and a demanding regulatory environment have significantly increased the responsibilities placed on directors of banking organizations. These increased complexities and responsibilities are likely to lead to upward adjustments in compensation for directors. The board should seek to adopt a compensation structure that is fair and competitive with those of peer organizations so that it can attract and retain the most qualified individuals.

The expanded obligations imposed on boards and the accompanying increase in time commitment, as well as enhanced independence and qualification standards, have presented challenges for banking organizations seeking to recruit new directors. These difficulties would be greatly exacerbated if directors were subject to a risk of personal liability in the absence of bad faith or disloyal conduct. In order to attract qualified directors, banking organizations typically provide directors with an appropriate level of protection against personal liability through indemnification provisions in the organization’s governing documents, indemnification agreements and/or directors and officers (“D&O”) insurance. State corporate law generally empowers a corporation to indemnify a director who is a party or is threatened to be a party to any action, suit or proceeding if that individual director acted in good faith and with a reasonable belief that the director’s conduct was in (or not opposed to) the best interests of the corporation. Moreover, corporations generally may

<sup>243</sup> See *id.* (noting that higher compensation for the chair and members of the audit committee is common).

<sup>244</sup> *Id.* at 106-07.

<sup>245</sup> *Id.*

provide insurance protection for their directors.<sup>246</sup> Federal banking regulations, however, limit the indemnification and the insurance coverage that an insured depository institution and its holding company can provide to a so-called “institution-affiliated party” in certain circumstances.<sup>247</sup> TCH believes that providing directors with liability protection in the form of indemnification and standard D&O insurance contracts, to the extent permitted by law and regulation, will generally be necessary to attract qualified directors and encourage these directors to undertake their responsibilities diligently without undue fear of personal liability.

## Section 15. Meetings with Regulators

### **Principles:**

**The board (or, as the board deems appropriate, specified directors) should seek to meet at least twice each year with the principal regulator(s) of the banking organization and, in any event, should inform each principal regulator that the board or specified directors are prepared to meet with the principal regulator, including in executive session, whenever the regulator requests.**

### **Commentary:**

Directors of banking organizations are held accountable by their principal regulators who supervise the organization through on-site examinations and periodic monitoring.<sup>248</sup> Open and honest communication with a banking organization’s principal regulators at the federal and state level is a critical component of a board’s oversight responsibilities and helps the banking organization in conducting its operations in compliance with laws, regulations and safe and sound banking principles.<sup>249</sup> The Federal Reserve Board states that it generally is preferable for regulators to meet with the full board, but that meetings with key board committees also may be sufficient.<sup>250</sup> In some instances conducting these meetings in executive sessions—*i.e.*, with only independent directors—may support a more candid discussion regarding sensitive issues at the banking organization. The OCC has acknowledged that outside

<sup>246</sup> See, *e.g.*, 8 Del. C. § 145.

<sup>247</sup> See 12 C.F.R. § 359.1.

<sup>248</sup> See OCC Director’s Book, at 1; Commercial Bank Manual, Section 5030.1, at 1.

<sup>249</sup> See Group of Thirty, A New Paradigm: Financial Institution Boards and Supervisors (October 2013) (“G30 New Paradigm”) (recognizing the mutual benefits of a robust and continuous interaction between the bank boards and the supervisors, and calling for “a long-term commitment to building and sustaining closer, trust-based relations founded on open communication” from the bank boards and the supervisors).

<sup>250</sup> Commercial Bank Manual, Section 5030.1, at 2.

directors may choose to meet with the OCC without management present.<sup>251</sup>

Accordingly, TCH believes that the board or, as the board deems appropriate, specified directors, should generally seek to meet at least twice each year with the principal regulator(s) of the banking organization. Depending on the issues involved, and in consultation with regulators, the board should consider whether all or part of these meetings should be in executive session without management present, and whether regulators should meet separately with the lead independent director or relevant committee chairs.<sup>252</sup>

In many cases, it will be beneficial to time these meetings so that the discussion can involve the outcome of bank examinations; board members are encouraged, and in certain circumstances required, to meet with federal and state bank examiners during, or at the conclusion of, the examination process for a bank holding company or subsidiary bank. As the Federal Reserve Bank of Kansas City has observed, attending exit meetings with regulators after the examination process provides an advance look at any strengths or weaknesses identified by the examiners.<sup>253</sup> For banking organizations that are subject to continuous supervision, the annual meeting with regulators should serve this purpose. In addition, the Federal Reserve Board also requires directors of a member bank to meet with the examiners if the bank's condition appears to be deteriorating or has shown little improvement since a prior examination.<sup>254</sup>

The OCC has recognized the benefits of an environment in which bank examiners and board members openly and honestly communicate.<sup>255</sup> Bank examiners often have experience with a broad range of banking activities and can provide independent, objective advice and information to the board on safe and sound banking principles, the organization's management, compliance

with applicable laws and regulations, weaknesses and potential areas of improvement.<sup>256</sup>

Directors should pay close attention to, and carefully review, any written communications from the banking regulators and discuss with management issues of concern raised in those communications. Directors also should receive reports from bank management as to the timely completion of any specific follow-up actions required by an examination report or specifically requested by the principal regulator.<sup>257</sup> The FDIC Pocket Guide states that board members should personally review reports of examinations and other correspondence from a banking organization's supervisors, including careful review of any findings and recommendations, should track progress in addressing problems and should discuss issues of concern with examiners. TCH believes that, for banking organizations that receive a large number of examination reports, a board may conclude that it is more appropriate for the board or a board committee to receive summaries that identify findings and recommendations and track progress.

In certain circumstances, bank regulators also may choose to take formal or informal enforcement actions to correct specific problems identified at a bank. Such actions typically specify what the banking organization "needs to do to correct identified problems, such as improving lending practices, raising capital, instituting proper policies and procedures, or correcting specific violations of law."<sup>258</sup> These enforcement actions may include specific requirements as to the board's role in remediating or monitoring the issue. Even absent specific requirements, the board of a banking organization should be fully briefed on these enforcement actions and should carefully review the identified problems and discuss issues of concern and the progress of remediation actions with the regulators and management.

It is important to recognize that the reviews by bank examiners do not diminish the board's responsibilities to oversee the management and operation of the banking organization. Directors are independently responsible for obtaining information from management as to the condition of the organization and should not rely on the examiners as their principal source of information to identify or correct problems. Instead, the board should look to its senior management, its auditors and other

251 See OCC Director's Book, at 7.

252 Traditionally, attendance of regulators and supervisors at board meetings has, in the normal course, been reserved for special sessions focused on the relevant issues. The presence of regulators or supervisors, even as observers, at regular board meetings raises a concern as to whether it will chill vigorous conversations among directors. See G30 New Paradigm, at 23 (noting that the regular presence of supervisors as observers at board meetings risks changing the behavior of the board and blurring the lines of accountability).

253 See Division of Supervision and Risk Management, Federal Reserve Bank of Kansas City, Basics for Bank Directors (January 2010) ("[Basics for Bank Directors](#)"), at 19.

254 See Commercial Bank Manual, Section 5030.1, at 3; Federal Reserve Board, Examination Frequency and Communicating with Directors, SR 85-28 (October 7, 1985), as amended by SR 95-19 (March 30, 1995).

255 See OCC Director's Book, at 7.

256 *Id.* See also G30 New Paradigm, at 28-29 (noting that supervisors have "unique and valuable insights at the intersection of financial stability, financial institutions, and regulatory implementation," such as a range of governance practices at the marketplace, which would greatly benefit the institutions).

257 *Id.*

258 *Id.* at 94.

outside experts to identify any problems and should work with these parties to correct these problems.<sup>259</sup>

The board should not necessarily limit its contact with principal regulators only to the examination process. The frequency with which the board should meet with the principal regulator(s) will of course depend on the circumstances at the banking organization.<sup>260</sup> TCH believes that the board or, as the board deems appropriate, certain designated directors should seek to meet with the primary regulators at least twice each year and that the board or such designated directors should indicate to the primary regulators a willingness to meet at any time, including meeting in executive sessions, that the regulators may request and should allow the primary regulators to meet with board committees or specific directors as those regulators deem necessary.

Section 16. Director Elections, Shareholder Rights and Shareholder Engagement

**Principles:**

**Public bank holding companies should be appropriately responsive to shareholder interests in protecting their voting franchise while recognizing a banking organization's special need for stability. The board, and in particular the independent directors, should remain apprised of and, as appropriate, help to guide and, as appropriate, participate with management in the organization's shareholder engagement approach and implementation.**

**Commentary:**

The past decade has seen a broad wave of changes in corporate governance for public companies, resulting from a combination of increased pressure from shareholder groups, evolving market practices, and regulation. The resulting changes have included the elimination of classified boards and the introduction of majority voting for directors at many companies, as well as the introduction of an advisory vote on executive compensation at public companies.<sup>261</sup> While recent trends have generally favored these and other shareholder empowerment provisions and have encouraged greater engagement with shareholders, TCH believes that banking

organizations should retain the flexibility to adopt the corporate governance structures and practices that the board believes are best suited to the organization, particularly in light of a banking organization's special need for stability to reassure its funding base.

Shareholder engagement is of increasing importance to public companies generally, including publicly held banking organizations. The board or the appropriate committee, such as the corporate governance/nominating committee, and in particular the independent directors, should remain apprised of the organization's shareholder engagement strategy and implementation. The board's or its committee's involvement in shareholder engagement can include overseeing the assessment of and response to director nominations and other shareholder proposals (as discussed further in Section 7 of these Governance Principles with respect to the role of the corporate governance/nominating committee) and having appropriate board or committee members, such as the lead independent director, meet with shareholders or shareholder groups that wish to convey concerns to the board (as discussed in Section 11 of these Governance Principles). ■

<sup>259</sup> See *id.* at 7.

<sup>260</sup> See G30 New Paradigm, at 23 & 35 (proposing that bank boards and supervisors should devote time and efforts to their interactions and meet regularly, and that the bank boards should be proactive in engaging supervisors in formal discussion about board effectiveness).

<sup>261</sup> See Dodd-Frank Act, § 951. Pursuant to Section 951 of the Dodd-Frank Act, issuers are required to conduct non-binding shareholder advisory votes on (i) executive compensation agreements (a "say-on-pay" vote) at least once every three years, (ii) whether a "say-on-pay" vote should be held annually, biennially or triennially (the "frequency vote") and (iii) certain golden parachute compensation arrangements of the company's named executive officers.

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# Annex A

# Annex A – Overview of 2014 Updates

The 2014 update incorporates various legal and regulatory developments and expands on certain topics, including the following:

- Bank regulatory and supervisory developments since 2012, including the Federal Reserve Board's February 2014 rules to implement enhanced prudential standards under the Dodd-Frank Act and the heightened risk management standards for certain large financial institutions finalized by the OCC in September 2014;
- The interplay between traditional state law fiduciary duties and the obligations imposed on boards by banking statutes, regulations and pronouncements (Section 1);
- The importance of enterprise-wide risk management and controls within a holding company structure, including the management of the oversight function at the holding company level and the avoidance of duplicative entity-level structures (Introduction, Section 4);
- The importance of the board and senior management establishing a “tone at the top” promoting an enterprise-wide culture of ethical behavior and compliance, including board oversight of a compliance reporting (or “whistleblower”) system (Sections 4 and 6);
- Board approval (rather than just review) of the company's strategic objectives, including a discussion of the varying ways in which these objectives can be expressed and documented (Section 4);
- The satisfaction of board responsibilities through the operation of board committees, including the use of joint committees, joint meetings or overlapping memberships in areas that are within the purview of multiple committees (Sections 5 and 9);
- Board oversight of management succession, and the varying forms that management succession plans can take (Section 4);
- Board diversity, director retirement policies and director tenure, including the importance of flexibility (Section 7);
- NYSE and Nasdaq compensation committee and compensation adviser independence rules that take effect in 2014 (Section 8);
- Risk committee structuring and composition considerations, including risk expertise requirements (Section 9);

- Independent leadership on the board in the context where the board determines that the CEO should serve as chair (Section 11);
- The development by the board of an approach for determining what matters should be addressed at the board and committee level (Section 12);
- The impact of potential liability concerns on director recruiting (Section 14);
- Semiannual meetings between the regulators and the board (or particular directors), and the desirability of timing these meetings with bank examination outcomes (Section 15); and

The involvement of the board, or a board committee, in shareholder engagement efforts (Section 16). ■

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