SULLIVAN & CROMWELL LLP

March 15, 2012

Guiding Principles for U.S. Banking Organization Corporate Governance

The Clearing House Association Issues Exposure Draft for Public Comment; Comments Requested by May 1

We wanted to bring to your attention the attached exposure draft of the *Guiding Principles for Enhancing Banking Organization Corporate Governance*, which was issued for public comment by The Clearing House Association, a trade association representing a number of the world's largest commercial banks. As discussed further in the attached press release and in the Principles themselves, the recent financial crisis resulted in an increased focus by regulators and other parties on the role of corporate governance in promoting safety and soundness of banking organizations. These Principles are intended to help guide U.S. banking organizations in considering corporate governance issues, though they are not designed to be prescriptive or to set minimum requirements applicable to all banking organizations. The Clearing House Association has requested comments by May 1.

Sullivan & Cromwell LLP assisted The Clearing House Association in preparing these Principles. We encourage our financial institution clients to review and comment on the Principles. We would be pleased to discuss any comments or observations you may have.

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Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

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CONTACTS

New York

H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Glen T. Schleyer	+1-212-558-7284	schleyerg@sullcrom.com
Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com

PRESS RELEASE

The Clearing House Association Issues Exposure Draft of Guiding Principles for Banking Organization Corporate Governance

Unique Industry Effort Aims to Enhance Safety and Soundness Through Common Understanding and Basic Framework

FOR IMMEDIATE RELEASE
March 13, 2011
CONTACT:
Erica Hurtt
VP, Communications
202.649.4603
erica.hurtt@theclearinghouse.org

New York, NY - The Clearing House Association, the oldest banking association in the United States, issued today for public exposure its draft *Guiding Principles for Banking Organization Corporate Governance* ("Governance Principles").

The Clearing House strongly believes that good corporate governance and an effective board are essential to promote a safe and sound banking system and a profitable enterprise.

"Our goal was to represent our members' best thinking on corporate governance and make it available to large U.S. banking organizations as they analyze their individual governance practices," said Edward P. O'Keefe, General Counsel of Bank of America and Chairman of The Clearing House Association Board of Managing Directors.

In the wake of the recent financial crisis, bank regulators have been increasing 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 usually legally required. These enhancements include:

- recommendations for a substantial majority (not just a majority) of independent directors and limited management presence on the holding-company board;
- a delineation of core elements of the board's oversight duties and responsibilities including risk management, capital planning, resolution plans, and liquidity risk;
- recommendations on the need for financial expertise on the audit committee;

The Clearing House℠

PRESS RELEASE

- a discussion of the need, if the same person serves as both CEO and chairperson of the board, for a lead independent director; and
- a recommendation that the board meet periodically with its principal bank regulators.

TCH's Governance Principles are intended to help guide banking organizations as they deal with corporate governance issues, but they 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 to its own situation.

Publication of the Governance Principles caps off a multi-month effort of TCH's Bank Governance Committee, chaired by Paul N. Harris, Secretary and General Counsel of KeyCorp, with the assistance of TCH's special counsel, Sullivan & Cromwell LLP.

"One key focus of the Guiding Principles was to emphasize the distinct roles played by a corporation's board of directors and its management," said Harris. "The board is responsible for overseeing the company and supervising management, while management is responsible for day-to-day operations. Expecting the board to take on management responsibilities can compromise the board's independence and create confusion about who is responsible for what. With the Guiding Principles we lay out these responsibilities to emphasize the need to keep the responsibilities separate."

"Governance practices are not static; they change in response to a variety of factors, including the expectations of regulators and investors," said Joseph R. Alexander, Senior Vice President, Deputy General Counsel, and Secretary of The Clearing House Association. "Because of this, we are committed to keeping them up to date and revising them as needed."

TCH welcomes comments from all interested parties by May 1, 2012. Interested parties may send their comments to governanceprinciples@theclearinghouse.org.

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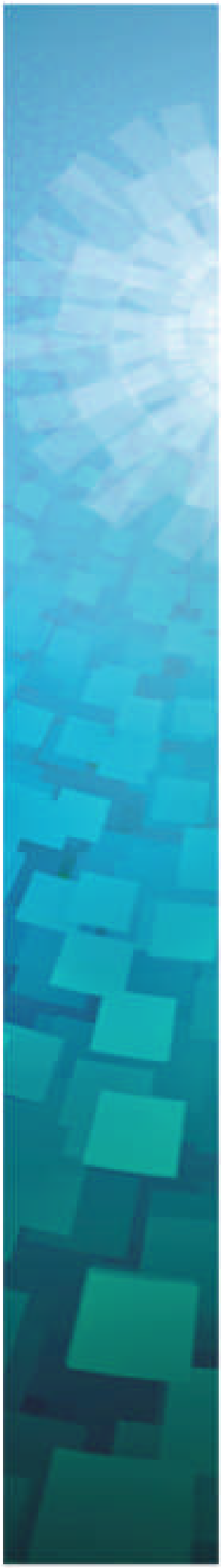
PRESS RELEASE

About The Clearing House
Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits.

The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues.

The Clearing House Payments Company L.L.C. provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S.

www.theclearinghouse.org



THE CLEARING HOUSE ASSOCIATION

GUIDING PRINCIPLES FOR ENHANCING BANKING ORGANIZATION CORPORATE GOVERNANCE

[TCH Exposure Draft Dated March 13, 2012]

[TCH Exposure Draft Dated March 13, 2012]

The Clearing House Owner Banks

Banco Santander, S.A.
Bank of America, National Association
The Bank of New York Mellon
Branch Banking and Trust Company
Capital One, National Association
Citibank, N.A.
Comerica Bank
Deutsche Bank Trust Company Americas
HSBC Bank USA, National Association
JPMorgan Chase Bank, National Association
KeyBank National Association
PNC Bank, National Association
Regions Bank
The Royal Bank of Scotland, N.V.
UBS AG
The Bank of Tokyo-Mitsubishi UFJ Limited
U.S. Bank National Association
Wells Fargo Bank, National Association

Advisor

Sullivan & Cromwell LLP
H. Rodgin Cohen
Michael M. Wiseman
Glen T. Schleyer

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

[TCH Exposure Draft Dated March 13, 2012]

March ___, 2012

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. 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 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 to its own situation.

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. 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 management's responsibility for day-to-day *operations* of the BHC. The board should not, absent extraordinary circumstances, involve itself in day-to-day operations as this likely will reduce the board's ability to perform its general oversight role effectively and create confusion and uncertainty as to responsibility. Indeed, if the board becomes too embroiled in day-to-day affairs of a banking organization, it 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. 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 avoid ad hoc and inconsistent 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. Accordingly, TCH expects to revisit these Governance Principles from time to time to assess whether changes or updates are appropriate, and 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.

These Governance Principles were prepared under the auspices of The Clearing House's Bank Governance Committee, with the assistance of TCH's special counsel, Sullivan & Cromwell LLP.

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Introduction

The Clearing House Association ("TCH") has developed these Governance Principles to provide guidance addressing a number of the core issues relating to corporate governance for U.S. banking organizations.[1] 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 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." Importantly, it should be noted that governance practices evolve over time, and TCH expects that these Governance Principles will be updated periodically to reflect changes in the relevant 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.

In the financial services 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, typically draws on the particular regulators' unique perspective and experience and should be considered carefully by banking organizations in light of their particular businesses and circumstances. 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, it is worth noting that regulations and supervisory guidance by bank regulators about corporate governance at the bank level are not determinative for bank holding companies, but they can provide important guidance for the boards of bank holding companies.

In the wake of the recent financial crisis, bank regulators have been increasing 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 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;

[1] These Governance Principles are principally designed for U.S. banking organizations because non-U.S. banking organizations (including their U.S. subsidiaries) are subject to a different set of governing laws and regulations.

- a delineation of core elements of the board's oversight duties and responsibilities in Section 4 (including regular board meetings with a discussion focused on risk management, capital planning, resolution plans and liquidity risk);
- recommendations on the need for financial expertise on the audit committee in Section 6;
- 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; and
- the Governance Principle on meetings with bank regulators in Section 15.

The paradigmatic structure contemplated by TCH in these Governance Principles is that of a top-tier public holding company with one or more wholly owned subsidiary banks (and typically non-bank subsidiaries). TCH generally intends these Governance Principles to apply to the banking organization as a whole, but with the understanding that the interplay between the holding company and the subsidiary bank will vary from organization to organization, and that an identical corporate governance approach often will not apply at a public holding company and at a wholly owned subsidiary.

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 can be seen as providing 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 issues for banking organizations generally. Nonetheless, a hallmark of a sound corporate governance structure is that it should be tailored as appropriate for the particular entity. U.S. banking organizations have a variety of different strategies, business mixes, products, cultures, customer bases and geographies. Within a framework of basic principles, each banking organization should develop the corporate governance structure that best corresponds to the needs of the individual organization, taking into account all the relevant factors. Accordingly, adherence to any particular principle may not be appropriate for an individual organization, but TCH believes that overall significant deviations from these Governance Principles by a banking organization should occur in a reasoned and deliberative manner.

It is to be emphasized that structure is an aid to, rather than the ultimate determinant of, effective corporate governance. That determinant, instead, consists of the quality, skills, expertise and judgment of the individuals who comprise the board and management of the banking organization. Having the right structure is of little use without the right people to work within it.

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) There is a crucial distinction between the respective roles of the board and of management in any corporation, including banking organizations.

(b) The board is responsible for making certain statutorily identified decisions and for conducting *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, as it deems appropriate;

(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 approving corporate governance principles and other appropriate policies and procedures applicable to the board and overseeing the development of a code of conduct applicable to directors and employees;

(v) selecting and evaluating the performance and compensation of the Chief Executive Officer ("CEO") and other senior executive officers;

(vi) approving a management succession plan for the CEO and other senior executive officers;

(vii) overseeing management's establishment and implementation or operation of a system designed to promote compliance with applicable laws and regulations;

(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;

(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 and liquidity) or that the board deems appropriate from time to time.

(b) The board may discharge these duties directly or through 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 respective boards 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 committees to assist the board in its oversight of (i) audit, (ii) nominating/ corporate governance, (iii) compensation and (iv) risk management activities and 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 the board may determine that it is 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, comprised 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 sufficient accounting, banking and related financial expertise and experience, including at least one member who is an audit committee financial expert under SEC rules.

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, comprised entirely of independent directors, to implement the director nominating process and assess the qualifications of directors.

(b) This committee (or another independent committee with which such committee coordinates) should be responsible for the board self-evaluation process and the oversight of the entity's corporate governance generally.

(c) This committee should establish factors to be considered in evaluating prospective nominees for directors and for members of the board committees, taking into account the circumstances and businesses of the banking organization and the responsibilities of the various committees.

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).

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. Chairperson of the Board

The board should determine whether the CEO of the banking organization should be the chairperson of the board. If the CEO serves as chairperson, the board should appoint a lead director who generally meets the following requirements:

(i) the lead director should be independent;

(ii) the lead director should approve the agenda and schedule for each board meeting; and

(iii) the lead director should chair regular executive sessions of the board (*i.e.*, sessions where no member of management (including the CEO) is present).

Section 12. Board Agenda, Materials for Board Meetings and Length of Meetings

(a) The agenda for each board meeting should ordinarily list each subject that is to be discussed at the meeting.

(b) Although board meetings generally should be confined to agenda subjects, it is recognized that, in practice, it may be necessary or appropriate to discuss matters that, because of the time at which they arose or for other reasons, are not on the agenda.

(c) Materials for board 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, in practice, circumstances may cause this time period to be shortened for some materials.

(d) There should be presentations by senior management and other employees of the company to the board covering major business, financial performance, risk and control, and legal and compliance matters.

(e) Directors should devote sufficient time to cover satisfactorily all agenda subjects and such other subjects as may be brought to the board's 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 a guide for 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 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 should seek to meet at least once each year with the principal regulator(s) of the banking organization and, in any event, should inform each principal regulator that the board, or a committee thereof, is prepared to meet with the principal regulator, including in executive session, whenever the regulator requests.

Section 16. Director Elections and Shareholder Rights

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.

Commentary

Section 1. Basic Responsibilities of the Board and Management

Principles:

(a) There is a crucial distinction between the respective roles of the board and of management in any corporation, including banking organizations.

(b) The board is responsible for making certain statutorily identified decisions and for conducting *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.[2] 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 . . . ."[3]

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 the responsibility of 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 routine of conducting 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.

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2 *See*, *e.g.*, 12 U.S.C. § 24 (conduct of business of national banks); 12 U.S.C. § 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 ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of 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 (1995).

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."[4] The Office of the Comptroller of the 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."[5] 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."[6] 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.[7]

Of course, the division of responsibilities between the board and management is not restricted to banking organizations and is generally applicable to corporate entities.[8] As the

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4 Commercial Bank Manual, Section 5000.1, at 1; *see also* Michael P. Malloy, Banking Law and Regulation, (2011) ("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").

5 OCC, The Role of a National Bank Director: The Director's Book (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 (stating that "[t]ogether with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance").

8 *See, e.g.*, *Schoonejongen* v. *Curtiss-Wright Corp*., 143 F.3d 120 (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*, 673 A.2d 1207, 1215 (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."); Committee on Corporate Laws, American Bar Association ("ABA") Section of Business Law, Corporate Director's Guidebook (6th ed., 2011) ("ABA Guidebook"), at 985 (stating that "[a]lthough the board is responsible for managing and overseeing corporate affairs, it typically delegates responsibility for day-to-day operations to a team of professional managers"); OECD Principles, at 58 (stating that "[t]ogether 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

ABA further explains, directors should provide leadership for the business organization through decision making and oversight.[9] In general, the board's oversight function involves (i) reviewing and approving corporate policy and strategic goals, (ii) hiring, evaluating and compensating 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.[10] 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."[11] 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 employees.[12] 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.

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[13] (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

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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 . . . .").

9 ABA Guidebook, at 985.

10 *Id*.

11 FDIC Pocket Guide.

12 *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 December 3, 2009) ("FDIC Statement") ("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.").

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

billion or more will be required to develop and 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 has proposed rules to implement the enhanced prudential standards and early remediation requirements mandated by Sections 165 and 166 of the Dodd-Frank Act, including requirements for board oversight, and certain of these rules establish, in granular detail, requirements for boards.[14]

Enforcement actions by bank regulators also have imposed expanded responsibilities on the boards of particular banking organizations in specific contexts. For example, recent 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."[15]

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.[16] The board also may assume a more active role as an organization experiences financial difficulty. For instance, under Delaware law, directors of an insolvent corporation may be required 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

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14 *See* Sections 4 and 9 for a further discussion on these proposed rules.

15 OCC, Consent Orders with National Bank Mortgage Servicers (April 13, 2011) (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) (collectively, the "Federal Reserve Consent Orders"), at 4 (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).

16 *See* OCC Director's Book, at 95.

decision making should be considered in that light.[17] Moreover, when directors are deciding to sell the company, they are charged with the duty to seek the best price for the shareholders.[18] In these circumstances, it is advisable for the board to take a more active role 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 require 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.

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17 *See Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

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

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 banking organizations to establish and maintain the independence of the board by including an appropriate number of independent directors on their boards. For instance, 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."[19] According to the OCC, 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."[20]

Regulators and commentators disagree as to whether significant stock ownership, or affiliation with a significant 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*. Similarly, the OCC carves out "stock ownership" from the factors compelling a non-independence determination. 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."[21] TCH believes that ownership of a significant stock position, or affiliation with such an owner,

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[19] OCC Director's Book, at 3.

[20] *Id.*; *see also* FDIC Statement (stating that banking institutions should establish and maintain the independence of the board); Basel Principles, at 10 ("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.").

[21] *See* Commercial Bank Manual, Section 5000.1, at 1.

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.[22] 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."[23]

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.[24]

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 indispensible 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.'"[25] In special circumstances, the board of a

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22 *See* NYSE, Listed Company Manual (2011) ("NYSE Manual"), Section 303A.01; NASDAQ, Listing Rules (2011) ("NASDAQ Rules"), Section 5605(b)(1).

23 NYSE Manual, Section 303A.01.

24 *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.

25 Walker Review, at 42; *see also* N.Y. Banking Law § 7001 (2011) (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).

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, 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.[26] 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."[27] 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 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 within the last three years;

(ii) the director 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) the director is or was affiliated with or employed by a present or former internal or external auditor of the listed company within the last three years;

(iv) the director 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;

(v) the director is or was an executive officer or an employee of another company that, within the last three years, made payments to, or received payments from, the listed company for property or services in an amount

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[26] NYSE Manual, Section 303A.02(a).

[27] *Id*.

> which, in any single fiscal year, exceeds the greater of $1 million and 2 percent of such other company's consolidated gross revenues; or
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> (vi) an "immediate family member" of the director has or has had any of the foregoing relationships within the last three years.[28]

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."[29] The term "executive officer" is defined by reference to the definition in Securities Exchange Act of 1934[30] (the "Exchange Act") Rule 16a-1(f), as follows:

> [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.[31]

This definition generally is consistent with that used for proxy disclosure purposes[32] 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.[33]

Federal bank regulators, the SEC and the national securities exchanges also have adopted regulations requiring the independence of directors serving in the board's audit, compensation and nominating/corporate governance committees.[34] These independence requirements are discussed in detail in Section 5 through Section 9 of these Governance Principles.

Independence and Composition of Subsidiary Bank Board

Federal bank regulators have not adopted specific independence requirements for boards of banks, although, as discussed above, they generally have cited the importance of

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

29 *Id*.

30 15 U.S.C. § 78a *et seq.*

31 NYSE Manual, Section 303A.02.

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

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

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

independent directors.[35] 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. Some appropriate models include the following:

(i) *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;

(ii) *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 holding company board itself will provide effective oversight while management directors are in the best position 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; and

(iii) *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 provide the core 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.

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.[36] TCH believes that it is desirable for the top-tier entity board, as the governing body of the controlling shareholder of the subsidiary bank, to review periodically the subsidiary bank's board structure.

Finally, the Depository Institution Management Interlocks Act[37] 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

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[35] 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).

[36] *See* NYSE Manual, Section 303A.00 and NASDAQ Rules, Section 5615(c).

[37] As implemented by Regulation L, 12 C.F.R. § 212.

provisions that may prohibit individuals from serving as directors or officers of two competing corporations.[38]

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

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:

(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.[39] 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.

[39] 8 Del. C. § 141.

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."[40] The ABA notes the substantial variation in the size of boards of public companies, but states that "except perhaps for the very largest and most complex corporations, smaller boards (7 to 11 members) generally function more effectively than larger ones."[41] 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.[42]

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).[43] 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.

Consequently, 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 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.

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40 *See* Basel Principles, at 11.

41 ABA Guidebook, at 1002.

42 *See id.*; *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.").

43 ABA Guidebook, at 1002, *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).

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.[44] State member banks also are subject to a 5–25 member range for board size.[45] 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.[46]

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.[47]

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44 12 U.S.C. § 71a; 12 C.F.R. § 7.2024(c); *see also* OCC Director's Book, at 3.

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

46 N.Y. Banking Law § 7002 (2011).

47 *See* Section 2 of these Governance Principles for a further discussion of the composition of subsidiary boards.

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, as it deems appropriate;

(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 approving corporate governance principles and other appropriate policies and procedures applicable to the board and overseeing the development of a code of conduct applicable to directors and employees;

(v) selecting and evaluating the performance and compensation of the Chief Executive Officer ("CEO") and other senior executive officers;

(vi) approving a management succession plan for the CEO and other senior executive officers;

(vii) overseeing management's establishment and implementation or operation of a system designed to promote compliance with applicable laws and regulations;

(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;

(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 and liquidity) or that the board deems appropriate from time to time.

(b) The board may discharge these duties directly or through 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 respective boards 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."[48] TCH believes that, subject to specific regulatory requirements at the bank level, including the obligation of the bank board to protect the bank, a banking organization should have flexibility in allocating oversight responsibilities between the bank board and the holding company board.

Strategic Objectives. The board's role in reviewing and approving the overall strategic objectives and plans of the banking organization, as formulated by management, is a

[48] 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).

reflection of the fact that it is ultimately responsible for the affairs of the organization.[49] 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.[50] 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."[51] TCH believes that the board should review and discuss overall strategic objectives on a regular schedule, as it deems appropriate.

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. Thus, the board should monitor the performance of the banking 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."[52] 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.[53] 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."[54] 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.[55] The OCC also recommends that the board use certain key financial ratios in order to gain "good insight into bank and management performance."[56] In addition, the OCC notes that, when reviewing reports prepared by management, the directors should be on alert for the

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49 *See*, *e.g.*, 12 U.S.C. § 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.

50 *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 (Del. Ch. 1956) (same); ABA Guidebook, at 985 (describing the board's responsibility for approving corporate policy and strategic goals).

51 *See* Commercial Bank Manual, Section 5000.1, at 2.

52 Basel Principles, at 9.

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

54 OCC Director's Book, at 34.

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

56 *Id*., at 42 (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 27 (describing metrics to gauge business performance of banking organizations).

appearance of "red flags" that may signal existing or potential problems and make prompt inquiry to resolve the issues raised.[57]

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."[58] The Basel Committee also recommends that the board should exemplify sound governance principles through its own practices.[59] 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."[60] Moreover, public companies, including public banking organizations, are required to adopt a code of conduct and make it publicly available on their websites.[61] TCH believes that the board of the top-tier entity within a banking organization should adopt such a code 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.[62]

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."[63] The OCC adds that the board or a designated board committee should actively

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57 *See* OCC, Director's Toolkit—Detecting Red Flags in Board Reports (reprint, Nov. 2010) (Feb. 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").

58 OCC Director's Book, at 20.

59 Basel Principles, at 11.

60 *Id*.

61 *See* NYSE Manual, Section 303A.10 and NASDAQ Rules, Section 5610.

62 *See Id*.

63 Commercial Bank Manual, Section 5000.1, at 2.

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."[64] 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."[65] The board also should review an appropriate management succession plan for the CEO and other senior executives.[66] 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.[67]

As discussed in more detail in Section 8 of these Governance Principles, the board 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.

Compliance. Because banking organizations are subject to an extensive regulatory scheme, compliance is one of the board's primary oversight responsibilities. 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 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, and the board should review these policies from time to time in light of changing legal requirements, as described further above under *Monitoring Management Performance*. 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. 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."[68] 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.

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64 OCC Director's Book, at 21.

65 *Id*.

66 *See* Basel Principles, at 9; ABA Guidebook, at 986.

67 *See* OCC Director's Book, at 23.

68 *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.").

As part of its compliance oversight function, the board also should review and approve a process for the treatment of claims or other reports by employees 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.[69] 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."[70] The structure of such reporting systems, including the role of the board or board committee, and the reliance on management for administrative support, will vary based on each organization's particular structure and the type of report.

Risk Management. Risk management 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.[71] Similarly, 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."[72] 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."[73] 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.[74] The board also should review the maintenance of sufficient capital and liquidity levels in light of the organization's risk profile as Congress and bank regulators have increasingly emphasized the importance of capital and liquidity planning in the aftermath of the financial crisis of 2008.[75]

Additionally, the Federal Reserve Board recently has proposed rules to implement the enhanced prudential standards and early remediation requirements mandated by Sections 165

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69 *See* Exchange Act Rule 10A-3(b)(3).

70 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).

71 Basel Principles, at 8.

72 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).

73 Commercial Bank Manual, Section 5000.1, at 2.

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

75 *See* Dodd-Frank Act, § 171(b)(2); 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) ("Risk-Based Capital Standards").

and 166 of the Dodd-Frank Act.[76] The proposed rules include a wide range of measures addressing capital, liquidity, stress testing, risk management and early remediation requirements and impose a number of specific duties on the board of directors. As discussed further in Section 9, the proposed 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 *stand-alone* committee of the board that will oversee enterprise-wide risk management. The proposed rules also establish minimum requirements governing the frequency of certain reviews and approvals by the board and the risk committee.[77] Specifically, under the proposed rules, the board of directors (or the risk committee) of a bank holding company with total consolidated assets of $50 billion or more is required to establish the company's liquidity risk tolerance—the acceptable level of liquidity risk the company may assume in connection with its operating strategies, taking into account factors such as capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors—at least annually.[78] The board of directors also is required to review and approve the company's contingency funding plan at least annually and whenever the company materially revises the plan.[79] Moreover, under the proposed rules, the risk committee or a designated sub-committee of the risk committee must review and approve the liquidity costs, benefits and risks of each significant new business line and each significant new product before the company implements the line or offers the product.[80] The risk committee or a designated sub-committee of the risk committee also is required to conduct quarterly reviews of key liquidity metrics, including cash flow projections, liquidity stress testing process and results, size and composition of the liquidity buffer and the specific limits on potential sources of liquidity risk.[81] Finally, the proposed 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.[82]

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 an increasing focus of regulatory scrutiny.[83]

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76 *See* Federal Reserve Board, Proposed Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (January 5, 2012) ("Proposed Enhanced Standards Requirements").

77 *Id*., at 656.

78 *Id.*, at 646.

79 *Id.*, at 646.

80 *Id*.

81 *Id*.

82 *Id*., at 647.

83 *See* Federal Reserve Board Release, Capital Plans, Regulation Y; Docket No. R-1425, 1, 4 (November 22, 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").

Resolution plans, or "living wills," have emerged as an area of supervisory and regulatory focus in the aftermath of the 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.[84] 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.[85]

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."[86] In a similar vein, the OCC notes that a national bank's charter imposes "significant responsibilities on it to serve the community."[87] 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."[88] 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 relationship involving the company and any director, executive officer or 5% shareholder.[89] 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."[90] 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

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84 *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 9, 2011) ("Interim Resolution Plan Rule") (requiring resolution plans for large depository institutions with total consolidated assets of $50 billion or more).

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

86 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").

87 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).

88 OCC Director's Book, at 47-48.

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

90 *Id*.

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 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 most subsidiaries of the bank).[91] The so-called "Volcker Rule" recently proposed by federal bank regulators to implement provisions of the Dodd-Frank Act, in addition to restricting proprietary trading and investing in and sponsoring private equity and hedge funds by banking organizations, also prohibits certain transactions between a banking organization or its affiliate, on the one hand, and "covered funds" that the banking organization sponsors or organizes and offers (including a covered fund controlled by such fund), on the other hand.[92] 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.[93] 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).[94] Furthermore, Section 22(g) and Regulation O impose additional restrictions on loans to any executive officer.[95] Publicly traded banking organizations are subject to additional restriction set forth in Section 402 of the Sarbanes-Oxley Act of 2002[96] (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.[97]

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."[98] 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

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91 *See* 12 U.S.C. §§ 371c and 371c-1.

92 *See* OCC, Federal Reserve Board, FDIC, SEC, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846, 68954 (proposed Nov. 7, 2011) ("Volcker Rule").

93 *See* 12 U.S.C. §§ 375a and 375b.

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

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

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

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

98 OCC Director's Book, at 74.

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. *Id*. 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.[99]

[99] Commercial Bank Manual, Section 5000.1, at 3; *see also* ABA Guidebook, at 993 (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).

Section 5. Board Committees

Principles:

(a) The board of the top-tier entity within a banking organization should establish committees to assist the board in its oversight of (i) audit, (ii) nominating/ corporate governance, (iii) compensation and (iv) risk management activities and 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 the board may determine that it is 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 boards 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 and create appropriate committees."[100] 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."[101] Accordingly, the board should create 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.

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

[100] OCC Director's Book, at 27.

[101] Commercial Bank Manual, Section 5000.1, at 4.

and the members meet all relevant independence and qualification criteria. In this regard, the Federal Reserve Board has proposed rules that would 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 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 securities exchange and SEC rules applicable to all listed public companies.[102]

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.[103] 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.[104] 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.[105] 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.[106] 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."[107]

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."[108] 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.[109] 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

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

103 Following the events of the recent 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.").

104 12 C.F.R. § 363.5.

105 *See* 12 C.F.R. Pt. 363, App. A.

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

107 OCC Director's Book, at 28.

108 OCC Director's Book, at 29.

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

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 committee should have a written charter that outlines a "clear statement of its mission, authority, responsibility, and duration."[110] According to the OCC, "Committee charters help ensure that important board functions are not neglected because of misunderstandings or incomplete delegations."[111] 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 have to meet periodically with management and the internal and external auditors to review the adequacy of 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 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."[112] 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 . . . [and] reflected in the minutes of said board or committee."[113]

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110 OCC Director's Book, at 28; *see also* NYSE Manual, Section 303A (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).

111 OCC Director's Book, at 28.

112 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.").

113 12 U.S.C. § 1823(e)(1)(C); *see also* OCC Director's Book, at 31 (discussing establishment and role of a loan committee).

The Relationship Between the Board and its Committees

State corporate law generally allows board committees to perform most board functions.[114] 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.[115] 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."[116] 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 summarize all significant decisions and actions taken at the committee meetings.

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114 *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").

115 *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).

116 ABA Guidebook, at 1015 ("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 . . . ."); *see also* OCC Director's Book, at 28 ("Committees should report regularly to the board.").

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, comprised 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 sufficient accounting, banking and related financial expertise and experience, including at least one member who is an audit committee financial expert under SEC rules.

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.[117] 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.[118]

Broadly stated, the audit committee has general oversight responsibility for a banking organization's financial reporting process, internal controls, and compliance policies and procedures, as well as responsibility for hiring and communicating with the banking organization's external auditors.[119] 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.[120] Further, as noted above in Section 4 of these Governance

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117 Sarbanes-Oxley Act, § 305.

118 *See, e.g.*, 12 C.F.R. § 363.5.

119 *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.").

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

Principles, the audit committees of public companies must establish procedures for the receipt, retention and treatment of complaints regarding accounting or auditing matters and for confidential, anonymous submission by employees of accounting or auditing concerns.[121]

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.[122] 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.[123]

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.[124] The audit committee of banking organizations with assets greater than $3 billion must "include members with banking or related financial management expertise."[125] 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). Finally, Item 407(d)(5)(i)(2) 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;

(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

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121 *See* Exchange Act Rule 10A-3(b)(3).

122 *See* 12 C.F.R. § 363.5.

123 *See* 12 C.F.R. Pt. 363, App. A.

124 *See* Sarbanes-Oxley Act, § 305; 12 C.F.R. § 363.5; Exchange Act Rule 10A-3; NYSE Manual, Section 303A.06; NASDAQ Rules, Section 5605(c).

125 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.").

issues that generally are comparable to the breadth and complexity of issues that can be reasonably 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.[126]

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.

[126] Regulation S-K, Item 407(d)(5)(ii).

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, comprised entirely of independent directors, to implement the director nominating process and assess the qualifications of directors.

(b) This committee (or another independent committee with which such committee coordinates) should be responsible for the board self-evaluation process and the oversight of the entity's corporate governance generally.

(c) This committee should establish factors to be considered in evaluating prospective nominees for directors and for members of the board committees, taking into account the circumstances and businesses of the banking organization and the responsibilities of the various committees.

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.[127] 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."[128] 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.[129]

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

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127 NYSE Manual, Section 303A.04; NASDAQ Rules, Section 5605(d)(1)(B).

128 OCC Director's Book, at 33.

129 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 and, in the case of not more than a minority of the total number of directors, the citizenship requirement).[130] 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.[131] 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.[132]

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."[133] 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,

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130 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.").

131 *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").

132 OCC Director's Book, at 4-5.

133 Basel Principles, at 10.

risk management, internal controls, bank regulation, auditing and compliance."[134] 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."[135]

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 diversity in areas of expertise and experience.[136] The nominating/corporate governance committee should focus on the strengths and weaknesses of the organization, its board and board committees and establish parameters that will attract director candidates who can provide needed additional talent and experience to the organization.[137] When considering director candidates, the nominating/ corporate governance committee also should consider the candidate's compatibility with the organization's corporate culture 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.[138]

In addition, the nominating/corporate governance committee should be the "conduit for communication regarding shareholder recommendations for director nominees."[139] 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. 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 creating director education and training programs.[140] As recommended by the Basel Committee, directors should be and remain qualified, including through training, for their positions.[141] Accordingly, directors should commit adequate time and effort to continuing

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134 *Id*.

135 ABA Guidebook, at 1034.

136 *See* OCC Director's Book, at 4 ("Many banks nominate directors on the basis of their independence, diversity, technical qualifications, and capabilities.").

137 *Id*.

138 ABA Guidebook, at 1034.

139 *See* ABA Guidebook, at 1035 & 1038.

140 *See* ABA Guidebook, at 1038.

141 Basel Principles, at 10.

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.[142] 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.[143] Because director selection is so central to an organization's corporate governance, it is common for the committee that its 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.

The nominating/corporate governance committee should develop a system for "formal and rigorous evaluation" of the performance of the board and its committees.[144] These

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142 *See also* OCC Director's Book, at 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).

143 *See* OCC Directors' Book, at 33 ("Over time, the nominating/corporate governance 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 1033 & 1037 (noting the committee's expanded role in addressing corporate governance principles and practices).

144 Walker Review, at 15.

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.[145] 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 Term Limits

The evaluation of a banking organization's director retirement policy also is generally under the purview of the nominating/corporate governance committee. Specifically, the nominating/corporate governance committee is responsible for reviewing and making recommendations with respect to the retirement policy applicable to directors.[146] Some banking organizations provide that directors shall not be re-nominated upon reaching a certain age (*e.g.*, 70 or 72), 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.

TCH does not believe that a banking organization should have term limits for directors—that is, limits on overall duration of service for individual directors. 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. 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."[147]

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145 *See* NYSE Manual, Section 303A; NASDAQ Rules, Section 5605.

146 *See* ABA Guidebook, at 1038.

147 ABA Guidebook, at 1035.

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 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).

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 pursuant to rules adopted by the national securities exchanges.[148]

In the aftermath of the financial crisis of 2008, the compensation policies of banking organizations became the subject of focus among regulators and commentators. In June 2010 the U.S. federal bank regulators issued the Guidance on Sound Incentive Compensation Policies[149] ("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, implementation and compliance with these principles.[150] 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.[151] 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

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148 *See* NYSE Manual, Section 303A.05; NASDAQ Rules, Section 5605(d)(1)(B).

149 75 Fed. Reg. 36,396 (June 25, 2010).

150 *See* Joint Guidance on Compensation, at 36,396.

151 *See Id*., at 36,398.

evaluations of the organization's compensation system and directly approve the incentive compensation arrangements for senior executives.[152] 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."[153]

Section 956 of the Dodd-Frank Act imposes additional oversight responsibilities with respect to compensation 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.[154] 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.[155] 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.[156]

Under Section 952 of the Dodd-Frank Act, each member of the compensation committee of a listed company must be independent under a new definition of "independence" that will be formulated by the national securities exchanges. In formulating a definition of "independence," the exchanges must consider (i) the sources of compensation of the director, including any consulting, advisory or other compensatory fee paid by the company to the director, and (ii) whether the director is affiliated with the company or any of its subsidiaries or their affiliates.[157] It remains to be seen whether and how the exchanges' definitions of "independence" for these purposes (which are expected to be issued in 2012) will differ from the general independence standards already applicable to compensation committee members under

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152 *Id.*, at 36412.

153 *Id.*, at 36,402. *See also* Walker Review, at 119 (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).

154 *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"), at 21,173.

155 *Id.*, at 21,173.

156 *Id.*, at 21,180.

157 *See* SEC Release, Listing Standards for Compensation Committees, Rel. Nos. 33-9199, 34-63149 (March 30, 2011) ("SEC March 2011 Release"), at 5.

existing listing standards. Section 952 of the Dodd-Frank Act and the proposed SEC rules also provide that a compensation committee must consider certain independence criteria for compensation advisers prior to hiring them.[158] Additionally, the SEC has proposed an amendment to Item 407 of Regulation S-K to require disclosure regarding the retention of compensation consultants and conflicts with compensation consultants.[159] 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.

Certain of these recent legislative and regulatory developments place 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."[160] 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.[161]

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 Financial Stability Board (the "FSB"), an international body of financial regulatory authorities, advises that staff engaged in financial and risk control should be compensated in a manner that is independent of the business areas they oversee.[162] In

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158 *Id.*

159 *Id*.

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

161 OCC Director's Book, at 33.

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

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.[163] 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.[164] 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. Moreover, in the Proposed Enhanced Standards Requirements, the Federal Reserve Board proposed that bank holding companies with total consolidated assets of $50 billion or more should be required 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.[165]

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 depend on the overall structure of the banking organization and will likely vary from organization to organization.

163 *Id*.

164 *Id*.

165 *See* Proposed Enhanced Standards Requirements, at 656.

Section 9. Risk Committees and Board Oversight of Risk Management

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 in that process. For instance, the Basel Committee states, "Risks 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."[166] Similarly, the OCC states that a banking organization's "safety and soundness are contingent upon effectively managing its risk exposures."[167] 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."[168] 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."[169]

The Dodd-Frank Act also imposed additional risk management responsibility on the board. As directed by Section 165(h) of the Dodd-Frank Act, the Federal Reserve Board has proposed 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 of the board of directors.[170] This risk committee will be responsible for the oversight of the enterprise-wide risk management practices of the company.[171] Under the Proposed Enhanced Standards Requirements, the committee is required to be chaired by an independent director, and the Federal Reserve Board encourages companies to include additional independent directors on the committee.[172] The Proposed Enhanced Standards Requirements do not, however, require that the committee be composed solely of

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166 Basel Principles, at 19.

167 OCC Director's Book, at 10.

168 *Id*., at 24.

169 Walker Review, at 90.

170 *See* the Proposed Enhanced Standards Requirements, at 656.

171 *Id.*

172 *Id*., at 623.

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 that would be required by the proposed rules.

The risk committee is required to include at least one member with "risk management expertise" commensurate with the company's capital structure, risk profile, complexity, activities, size and other appropriate risk related factors.[173] Furthermore, the Federal Reserve Board advises that the members of the committee generally should have an understanding of risk management principles and practices relevant to the company.[174]

There is currently no regulatory requirement that the audit committee and the risk committee be entirely separated from each other. The Proposed Enhanced Standards Requirements, however, would require that the risk committee not to be combined with any other committee.[175] As a general governance matter, TCH believes that 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 is not undermined and the members meet all relevant independence and qualification criteria. It remains to be seen, however, if the final rules adopted by the Federal Reserve Board will allow this for large bank holding companies. In any event, if the board creates separate audit and risk committees, there should be appropriate coordination between these committees, possibly including joint members or periodic joint meetings, as appropriate so that the financial reporting, internal control and risk management environments of the company are considered together. In fact, NYSE rules require the audit committee to maintain some oversight over the company's risk management.[176]

In addition to these Dodd-Frank Act requirements, regulations promulgated by the SEC in recent years 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.[177] Public companies also are required to disclose the extent of the board's role in risk oversight.[178] 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.[179]

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173 *Id.*, at 624.

174 *Id.*, at 624.

175 *Id.*, at 625.

176 *See* NYSE Manual, Section 303A.07(b)(iii)(D).

177 *See* Item 402(s) of Regulation S-K.

178 *See* Item 407(h) of Regulation S-K.

179 *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* Proposed Enhanced Standards Requirements, at 656 (requiring the risk committee to oversee the operation of

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 its own legal counsel and professional advisors when they determine such direct advice is desirable.[180] 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.[181] Securities exchange listing standards provide similar authority for the compensation and nominating/corporate governance committees.[182]

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.[183] In certain circumstances, particularly 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.

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an enterprise-wide risk management framework, including integration of risk management and control objectives in management goals and the company's compensation structure).

180 *See* ABA Guidebook, at 989.

181 *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).

182 *See* NYSE Manual, Section 303A.05 and NASDAQ Rules, Section 5605(c).

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

Section 11. Chairperson of the Board

Principles:

The board should determine whether the CEO of the banking organization should be the chairperson of the board. If the CEO serves as chairperson, the board should appoint a lead director who generally meets the following requirements:

(i) the lead director should be independent;

(ii) the lead director should approve the agenda and schedule for each board meeting; and

(iii) the lead director should chair regular 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.[184] 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."[185]

In the United States, it is common for the CEO of a corporate entity also to serve as the chairperson.[186] The ABA notes, however, that in a growing number of public companies, the two functions are separated.[187] It has been suggested that separation helps to establish appropriate "checks and balances" between the board and management.[188] On the other hand, many organizations have determined that separation can cause inefficiencies, and even friction, between the board and management, and that the appropriate checks and balances can be provided in other ways, such as by having a lead independent director.

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

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184 *See* Basel Principles, at 12.

185 *Id.*

186 *See* ABA Guidebook, at 1005 ("For many public companies in the United States, the CEO of the corporation also serves as chair of the board.").

187 *Id.*

188 Basel Principles, at 12.

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.[189] 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 it has a lead independent director and what specific roles the lead director plays in the leadership of the board.[190]

If the board determines that it is advisable to combine the positions of CEO and 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 director.[191] 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.[192] 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.[193] If the board of a banking organization decides to separate the positions of CEO and the chairperson, the latter should be available to serve as the board's liaison to the CEO and facilitate communication between them.

The lead director or independent chairperson 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.[194] In the United States, public companies are required to hold executive sessions of independent directors on a regularly scheduled basis.[195] 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 to 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.[196]

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189 *See* ABA Guidebook, at 1005 (noting that there is no one-size-fits-all prescription and that the board should thus decide what works best for its organization).

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

191 *See* ABA Guidebook, at 1005 (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).

192 *Id. See also* Institutional Shareholder Services Inc., 2011 U.S. Proxy Guidelines Summary, at 20 (January 27, 2011).

193 *Id.*

194 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.

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

196 *See* ABA Guidebook, at 1007.

Section 12. Board Agenda, Materials for Board Meetings and Length of Meetings

Principles:

(a) The agenda for each board meeting should ordinarily list each subject that is to be discussed at the meeting.

(b) Although board meetings generally should be confined to agenda subjects, it is recognized that, in practice, it may be necessary or appropriate to discuss matters that, because of the time at which they arose or for other reasons, are not on the agenda.

(c) Materials for board 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, in practice, circumstances may cause this time period to be shortened for some materials.

(d) There should be presentations by senior management and other employees of the company to the board covering major business, financial performance, risk and control, and legal and compliance matters.

(e) Directors should devote sufficient time to cover satisfactorily all agenda subjects and such other subjects as may be brought to the board's attention.

Commentary:

Agenda

The agenda for board meetings generally dictates what the directors will discuss at the meetings and should therefore list each subject that is to be considered at the meeting. The duty of setting the agenda for the board 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.[197] 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 devoting time to the important matters.[198] 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. In this regard, banking organizations may consider establishing a formal system for gathering feedback and views regarding potential agenda subjects from individual directors.[199]

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197 *See* ABA Guidebook, at 1006.

198 *See* Lowy–Directors, at 78.

199 *See* ABA Guidebook, at 1006.

Although the agenda normally controls the flow and the content of the meeting, the board nonetheless can address matters not on the agenda if circumstances so warrant. For example, it may be necessary or appropriate for the board to discuss a matter that may create 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.[200]

Materials for Meetings

Comprehensive and quality information is critical for the board to function effectively and essential 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.[201] Accordingly, materials for a board 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, the board is 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 the board reasonably believes to be reliable and competent.[202]

Meeting materials should be furnished to the directors sufficiently in advance of the meeting to allow time for careful study and thoughtful reflection.[203] 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 meeting, rather than being included in the board 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.[204] Consequently, it is important, especially in

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200 *See* ABA Guidebook, at 1006.

201 ABA Guidebook, at 1006.

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

203 *See* ABA Guidebook, at 1006; *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).

204 *See, e.g.*, *Smith* v. *Van Gorkom*, 488 A.2d 858 (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 (Del.

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 board meeting. Directors in turn should review such materials carefully before the meetings to make certain that they are able to participate meaningfully and actively in the deliberative process.[205]

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.

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.[206] 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 meetings. On the one hand, board meetings that are too brief can prevent the board from effectively fulfilling its oversight responsibility and may adversely impact the banking organization's strategies and performance. On the other hand, prolonged board 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 board meetings will tend to correlate with the quantity and significance of the subjects on the agenda. Nonetheless, the board should devote sufficient time to address each subject on the agenda fully and satisfactorily and also consider other subjects that may be brought to the board's attention.

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).

205 *See* ABA Guidebook, at 988.

206 *See, e.g.*, Colley–Governance, at 83.

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 a guide for 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 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.[207] 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 committee's 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 but should cover, at a minimum, a description of significant subjects discussed, 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.[208]

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."[209]

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[207] *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. Law § 624(a) (requiring corporations to keep minutes of the proceedings of its shareholders, board and executive committee, if any).

[208] *See* Commercial Bank Manual, Section 5000.1, at 4.

[209] *Id.*

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 that the position be recorded in the minutes.[210] These prescriptions regarding the minutes of board meetings apply equally to meetings of its various committees.[211]

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.[212] 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.[213] 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.[214]

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."[215]

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210 *See* OCC Director's Book, at 73.

211 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).

212 *See* ABA Guidebook, at 1009 (noting that directors have no obligation to take notes).

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

214 *See*, *e.g.*, 8 Del. C. § 220(b).

215 ABA Guidebook, at 1008.

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.[216]

Typically, the nominating/corporate governance committee or compensation committee of the board is charged with evaluating the form and amount of director compensation and presenting it to the full board for approval. 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 for directors who serve in such positions typically is higher.[217]

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.[218] 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."[219] In addition, the board of banking organizations may consider requiring

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[216] *See, e.g.*, ABA Guidebook, at 1039 (noting that boards should make sure they have "considered the information necessary to reach a fair decision" regarding its compensation, including "data on peer companies, together with an analysis of any special factors that may relate to their particular corporation, such as the complexity of the corporation and expected time commitment").

[217] *See* ABA Guidebook, at 1039 (noting that higher compensation for the chair and members of the audit committee is common).

[218] *Id*.

[219] *Id*.

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 to those of peer organizations so that it can attract and retain the most qualified individuals.

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 provide insurance protection for their directors.[220] 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.[221] 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.

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[220] *See, e.g.*, 8 Del. C. § 145.

[221] *See* 12 C.F.R. § 359.1.

Section 15. Meetings with Regulators

Principles:

The board should seek to meet at least once each year with the principal regulator(s) of the banking organization and, in any event, should inform each principal regulator that the board, or a committee thereof, is 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.[222] 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. 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.[223] 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 directors may choose to meet with the OCC without management present.[224] Accordingly, TCH believes that the board should seek to meet at least once each year with the principal regulator(s) of the banking organization and should consider whether all or part of these meetings should be in executive session without management present.

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.[225] 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.[226]

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222 *See* OCC Director's Book, at 1; and Commercial Bank Manual, Section 5030.1, at 1.

223 Commercial Bank Manual, Section 5030.1, at 2.

224 *See* OCC Director's Book, at 7.

225 *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; *see also* Federal Reserve Board, SR 08-1 (January 24, 2008) ("Federal Reserve Board–SR 08-1") (noting that an important part of the examination and inspection of banking organizations is the communication of findings to the directors and senior management).

226 *See* Commercial Bank Manual, Section 5030.1, at 3; Federal Reserve Board, SR 85-28, October 7, 1985, as amended by SR 95-19 (March 30, 1995) ("Federal Reserve Board–SR 85-28").

The OCC has recognized the benefits of an environment in which bank examiners and board members openly and honestly communicate.[227] 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.[228]

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.[229] 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."[230] 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 outside experts to identify any problems and should work with these parties to correct these problems.[231]

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

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227 *See* OCC Director's Book, at 7.

228 *Id*.

229 OCC Director's Book, at 7.

230 OCC Director's Book, at 94.

231 *See* OCC Director's Book, at 7.

regulator(s) will of course depend on the circumstances at the banking organization. TCH believes that the board should seek to meet with the primary regulators at least once each year and that the board should indicate to the primary regulators its willingness to meet at any time, including in executive sessions, that the regulator may request and should allow the primary regulators to meet with board committees as those regulators deem necessary.

Section 16. Director Elections and Shareholder Rights

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.

Commentary:

The past decade has seen a broad wave of changes in corporate governance structures for public companies, resulting largely from increased pressure from shareholder groups and evolving market practices rather than direct regulation. These changes have included elimination of classified boards and the introduction of majority voting for directors. Although recent trends have favored these and other shareholder empowerment provisions, TCH believes that banking organizations should retain the flexibility to utilize such corporate governance structures as they believe are best suited to the organization. This view is based in large part on a banking organization's special need for stability to reassure its funding base.

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