January 21, 2014

Heightened Risk Governance Standards for Banks and Bank Boards of Directors

Proposed OCC “Guidelines” Would Establish Heightened Standards for Large National Banks’ Risk Governance Frameworks and Boards of Directors, and Accelerate Trends of Regulatory Involvement and Reliance on Enforcement

SUMMARY

On January 16, 2014, the Office of the Comptroller of the Currency (the “OCC”) solicited public comment, through a Notice of Proposed Rulemaking (the “NPR”), on proposed “guidelines” to establish minimum standards for the design and implementation of risk governance frameworks by certain large banks and minimum standards for the boards of directors of those banks in overseeing the frameworks’ design and implementation (the “Guidelines”). The NPR describes the Guidelines as building upon and formalizing informal “heightened expectations” for risk governance developed by the OCC in 2010 and as intended to improve examiners’ ability to assess compliance with the OCC’s expectations.

The Guidelines would be issued and enforceable under section 39 of the Federal Deposit Insurance Act (the “FDI Act”), which authorizes the OCC to prescribe safety and soundness standards. They would apply to insured national banks, insured Federal savings associations, and insured Federal branches of foreign banks with average total consolidated assets of $50 billion or more, as well as potentially smaller insured depository institutions (together, “Banks,” and each, a “Bank”). The Guidelines would appear as a new Appendix D to Part 30 of the OCC’s rules.

The Guidelines establish specific risk management-related roles and responsibilities for three designated functions: a Bank’s “front line” units, independent risk management, and internal audit. The Guidelines require the three functions to maintain independence from each other. The Guidelines also impose substantial risk management-related and other responsibilities on the Bank’s board of directors (the
A principal theme of the Guidelines is that a Bank is expected to evaluate and manage its risk separately and apart from its parent organization. This approach has been described by the OCC as involving the “sanctity of the charter.”

Although larger national banks have already implemented many of the elements of the proposed Guidelines, they would represent a significant development in at least four respects. First, the prescriptiveness of the Guidelines represents an acceleration of a trend toward increased regulatory involvement in the processes and procedures of banking organizations. Second, the Guidelines continue a trend towards use of enforcement as a principal regulatory tool. The NPR explicitly describes the Guidelines as “enforceable guidelines” to be enforced through “formal, public” orders. Third, the Guidelines require an increased responsibility for the boards of directors. Fourth, the Guidelines frequently reference board or management “ensuring” a prescribed result. This standard would be highly problematic absent a definition of this term along the lines often used by the OCC in Consent Orders.5

Although the OCC requests comment on all aspects of the NPR, the five specific questions posed in the NPR do not address a number of its most problematic aspects. The NPR leaves unanswered the interplay between the Guidelines and the supervisory expectations of other Federal banking regulators for institutions subject to their respective jurisdictions. In particular, the independent risk management required by the Guidelines at the national bank level could create tension with the enterprise-wide risk management expectations of the Board of Governors of the Federal Reserve System (the “Federal Reserve”) for the banking organization as a whole. In this regard, it will be important to reconcile the OCC’s approach in the Guidelines with the Federal Reserve’s proposed rules issued under Section 165 of the Dodd-Frank Act,6 which would establish such enterprise-wide risk management expectations.7

Comments on the NPR are due by 60 days after its publication in the Federal Register.

BACKGROUND

The NPR notes that, following the financial crisis, the OCC developed a set of five “heightened expectations” intended to enhance the OCC’s supervision and strengthen the governance and risk management practices of large national banks and to enhance the agency’s supervision of those institutions.8 The OCC began communicating these heightened expectations informally to banks in the Large Bank program9 in 2010, and began examining banks for compliance in 2012. The NPR indicates that the OCC has also applied “aspects” of the heightened expectations to banks in the “Midsize Bank”
program. According to the NPR, the Guidelines build upon and formalize those expectations to provide additional clarity and specificity, but also to apply to a broader group of financial institutions.

The Guidelines would be issued pursuant section 39 of the FDI Act, which authorizes the OCC to prescribe, by regulation or guidelines, safety and soundness standards for the insured depository institutions (the “IDIs”) it regulates. If an IDI fails to meet standards prescribed by these guidelines, the OCC has discretion to require the IDI to submit a plan specifying the steps the institution will take to comply. If, after an IDI is notified that it is in violation of a safety and soundness standard, the IDI fails to submit an acceptable compliance plan or fails in any material respect to implement an accepted plan, the OCC may issue a formal, public enforcement action under section 39, which would take the form of an order under section 8(b) of the FDI Act. The OCC could enforce the order in Federal court or through the assessment of civil money penalties.

**APPLICATION OF THE GUIDELINES**

Although the underlying rationale for the Guidelines is the “recent financial crisis [that] demonstrated the destabilizing effect [of] large, interconnected financial companies,” the Guidelines apply broadly to all IDIs that qualify as Banks as of the effective date of the Guidelines, i.e., that have $50 billion or more in consolidated assets. Whether a bank’s average total consolidated assets meet the minimum $50 billion threshold is determined based on the average of the institution’s total consolidated assets, as reported on its Call Reports, for the four most recent consecutive quarters. A bank that qualifies under the Guidelines after the effective date is subject to the Guidelines beginning on the as-of date of the most recent Call Report used in determining its average. A Bank that at any point becomes subject to the Guidelines must continue to comply with the Guidelines even if its average total consolidated assets subsequently drop below the $50 billion threshold, although the OCC would retain the discretion to determine that such a Bank need not continue to comply with the Guidelines.

The OCC also reserves the right to apply the Guidelines to institutions that do not meet the $50 billion threshold if the institution’s operations are highly complex or otherwise present a heightened risk. In this regard a bank with average consolidated assets of less than $50 billion would apparently be considered a “heightened risk,” and required to comply with the Guidelines, if its parent owns more than one bank and the aggregate average total consolidated assets of all the bank subsidiaries is equal to or greater than $50 billion.

**LIMITED ABILITY TO RELY ON PARENT’S FRAMEWORK**

Under the Guidelines, a Bank may theoretically use its parent’s risk governance framework but only if that framework meets the minimum standards in the Guidelines and the risk profiles of the Bank and its parent are “substantially the same,” as demonstrated by the Bank through a documented assessment. The definition of “substantial similarity,” however, is so limited as to make the availability of this reliance close
Heightened Risk Governance Standards for Banks and Bank Boards of Directors
January 21, 2014

to non-existent. This phrase is defined to require that, as of the most recent quarter-end Call Report, each of the Bank’s average total consolidated assets, total assets under management, and total off-balance sheet exposures represents at least 95 percent of the parent’s respective averages.

If the risk profiles of the Bank and its parent are not substantially the same, the Bank is expected to establish its own risk governance framework (“Framework”), although it is permitted under the Guidelines to submit to the OCC for consideration an analysis that demonstrates that the Bank’s and its parent’s risk profiles are substantially the same based on other factors. A Bank that is required to establish its own Framework may, in consultation with OCC examiners, use components of its parent’s risk governance framework, but should ensure that the Bank’s risk profile is easily distinguished and separate from that of its parent for risk management and supervisory reporting purposes, and that the Bank’s safety and soundness is not jeopardized by decisions made by the parent’s board of directors and management.

- The OCC requests comment on the proposed conditions for determining whether a Bank’s risk profile is substantially the same as its parent’s risk profile.

**HEIGHTENED STANDARDS FOR RISK GOVERNANCE FRAMEWORK**

The Guidelines would require Banks to establish and adhere to a formal, written Framework, designed by independent risk management and approved by the Board (or the Board’s risk committee), which would encompass risks to the Bank that arise from all its activities, including risks associated with third-party relationships. The Framework would be implemented through the three-function process described below. The Framework should be based on the Bank’s risk appetite statement and include, among other things, concentration risk limits and front line unit risk limits for the relevant risks. Banks are expected to establish processes that require front line units and independent risk management to identify breaches of the risk appetite statement, concentration risk limits, and front line unit risk limits, protocols for when and how to inform the Board, function management, and the OCC of such breaches, and processes that provide accountability for reporting and resolving breaches.

The Bank’s risk appetite statement, concentration risk limits, and front line unit risk limits must be incorporated into the Bank’s strategic and annual operating plans, capital stress testing and planning, liquidity stress testing and planning, product and service risk management processes, decisions regarding acquisitions and divestitures, and compensation and performance management programs.

Independent risk management is expected to review and update the Framework as often as necessary to address changes in the Bank’s risk profile, but at least annually.

The Framework should be supported by appropriate procedures and processes, including data architecture and information technology structure, and appropriate talent management processes and compensation and performance management programs. The Guidelines establish specific requirements for these processes and programs aimed at ensuring that management and employees who are
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responsible for or influence material risk decisions have the knowledge, skills, and abilities to effectively identify, measure, monitor, and control relevant risks, and adhere to the Framework.

1. Risk Appetite Statement

The Guidelines define “risk appetite” as the aggregate level and types of risk the Board and management are willing to assume to achieve the Bank’s strategic objectives and business plan, consistent with regulatory requirements. The Bank’s risk appetite statement should include both qualitative components, including a description of a safe and sound risk culture, and quantitative limits that include, as appropriate, stress testing processes described in the May 2012 interagency guidance on stress testing. If the Bank’s and its parent’s risk profiles are substantially the same, the Bank’s Board may tailor the parent’s risk appetite statement to apply to the Bank; however, to ensure the sanctity of the Bank’s charter, the Guidelines require the Bank’s Board to approve the Bank-level risk appetite statement and document any needed adjustments or material differences between the risk profiles of the Bank and its parent. The Framework should require the Board to review and approve the risk appetite statement no less than annually. The Framework should also require the statement to be communicated and reinforced throughout the Bank to ensure that employees align their risk-taking decisions with the statement.

2. Risk Management-Related Roles and Responsibilities

Fundamental to the design and implementation of the Framework are the specific risk-related roles and responsibilities imposed by the Guidelines on three functions: front line units, independent risk management and internal audit. Many of the roles and responsibilities are distinct to each function, although some are shared across multiple functions. All three functions, for example, are responsible for ensuring that the Board is adequately informed about risks and are subject to requirements related to talent management processes and compensation and performance management programs. Independent risk management and internal audit are required to have unfettered access to the Board – access the NPR characterizes as critical to ensuring the Framework’s integrity. The Guidelines also require those two functions to be afforded the stature within the Bank needed to effectively carry out their respective roles and responsibilities – stature the NPR similarly characterizes as critical to ensuring the Framework’s effectiveness. Those two functions are specifically authorized to hire external resources. Key differences in roles and responsibilities of the three functions are discussed below. Also discussed below are risk management-related responsibilities assigned to the CEO.

a. Front Line Units

Under the Guidelines, a “front line unit” is broadly defined as any unit that engages in activities designed to generate revenue for the Bank or its parent, or that provides services to the Bank or support to any unit covered by the Guidelines. Seemingly, this covers virtually every unit within the Bank. Each front line unit is expected to “own” the risks associated with its activities. Each unit must assess, on an ongoing
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basis, material risks associated with its activities. The unit must use these risk assessments as the basis for fulfilling its related responsibilities to, among other things, implement policies that address unit risk limits and ensure that risks associated with the unit’s activities are effectively identified, measured, monitored and controlled, consistent with the Bank’s risk appetite statement, concentration risk limits, and policies established within the Framework. Each front line unit is expected to use its risk assessments to determine if additional measures need to be taken to strengthen risk management or reduce risk.

b. Independent Risk Management

The Guidelines define “independent risk management” as the unit within the Bank that is responsible for identifying, measuring, monitoring, and controlling aggregate risks, independent of the CEO and front line units. Independent risk management is tasked with primary responsibility and accountability for designing a Framework that complies with the Guidelines and must be led by a Chief Risk Executive (“CRE”), who must report directly to the CEO. Independent risk management is expected to identify and assess, on an ongoing basis, the Bank’s material aggregate risks, and use those risk assessments as the basis for enterprise risk policies that address concentration risk limits and ensure that aggregate risks are effectively identified, measured, monitored and controlled, consistent with the Bank’s risk appetite statement, concentration risk limits, and policies and processes established within the Framework. Independent risk management’s risk assessments should also be used to determine if additional measures should be taken to strengthen risk management or reduce risk.

Independent risk management is also responsible for ensuring that the front line units fulfill their risk management-related responsibilities under the Guidelines, and for identifying material risks and significant instances in which independent risk management’s assessment of risk differs from that of a front line unit or the CEO, a front line unit or the CEO is not adhering to the Framework, or the CEO is not holding a front line unit accountable for adhering to the Framework. Where independent risk management identifies such material risks or significant instances, it is to communicate them to the Board and, in the case of a front line unit, to the CEO.

- The OCC requests comment on the advantages and disadvantages of having a single CRE, such as a Chief Risk Officer, provide oversight to all independent risk management units versus having multiple, risk-specific CREs provide oversight to one or more independent risk management units.

c. Internal Audit

Internal audit is responsible for ensuring that a Bank’s Framework complies with the Guidelines and is led by the Chief Accounting Executive (“CAE”), who must report directly to the CEO. In fulfilling that responsibility, internal audit is expected to maintain a complete and current inventory of the Bank’s material business, product lines, services, and functions, and to assess and rate the risks associated with each, including activities the Bank may outsource to a third party.
The OCC requests comment on whether the Guidelines should require that independent risk management also maintain such an inventory in order to ensure that internal audit has identified all material businesses, product lines, services and functions.

These risk assessments and ratings are to provide a basis for an audit plan, updated no less than quarterly, that takes into account the Bank’s risk profile and emerging risks and requires internal audit to evaluate the adequacy of and compliance with policies, procedures and processes established by front line units and independent risk management under the Framework. Changes to the audit plan and conclusions, issues, and recommendations from audit work carried out under the audit plan are to be communicated to the Board’s audit committee. The Guidelines impose specific requirements on the contents of such reporting.

Under the Guidelines, internal audit should also establish and adhere to processes for independently assessing the design and effectiveness of the Framework on at least an annual basis. This assessment, which may be conducted by internal audit and/or a third party, should include a conclusion on the Bank’s compliance with the Guidelines and the degree to which the Bank’s Framework is consistent with leading industry practices.

The OCC requests comment on whether internal audit's assessment of the Bank’s Framework should include a conclusion regarding whether the Framework is consistent with leading industry practices, and asks whether such an assessment is possible given the wide range of practices in the industry and the challenges associated with determining what constitutes a leading industry practice and whether there are any other concerns with such a requirement. (It is difficult to understand how such an assessment could be made without reliance on a third party.)

Internal audit is further tasked with identifying and communicating to the Board’s audit committee significant instances in which front line units or independent risk management are not adhering to the Framework. It must also establish a quality assurance department to ensure that internal audit’s policies, procedures, and processes comply with applicable regulatory and industry guidance, and are appropriate for the Bank’s size, complexity, and risk profile.

d. CEO

The Guidelines also impose specific risk management-related responsibilities on the CEO. Under the Guidelines, the CEO is responsible for developing, with input from the three functions described above, a minimum three-year strategic plan that includes a comprehensive assessment of risks to the Bank during the time period covered by the plan and an explanation of how the Bank will update the Framework to account for changes in the Bank’s risk profile as projected under the strategic plan. The strategic plan must be approved by the Board and reviewed, updated, and approved to reflect changes in the Bank’s risk profile or operating environment. The CEO is also required to oversee the day-to-day activities of the CRE and CAE.
HEIGHTENED STANDARDS FOR BOARD OF DIRECTORS

The Guidelines impose a number of new requirements relating to the composition of the board of directors and the responsibilities of the board and individual directors. These include the following:

- At least two members of a Bank’s board must be “independent,” i.e., not members of the management of the Bank or its parent. A Bank’s independent director that is also a member of the parent’s Board is expected to consider the safety and soundness of the Bank in decisions made by the parent that impact the Bank’s risk profile. This requirement, plus the other new requirements described below, places an increased burden on the independent directors and may discourage individuals from serving in that capacity.

- A Bank’s Board must “ensure” the Bank establishes and implements an effective Framework that complies with the Guidelines and is responsible for approving any changes to that Framework.

- The Board’s basic duty of oversight is described as requirements for the Board to “actively” oversee the Bank’s risk-taking activities, “acquire a thorough understanding of the Bank’s risk profile,” and hold management accountable for adhering to the Framework, including by questioning, challenging and opposing management decisions that could cause the Bank’s risk profile to exceed its risk appetite or jeopardize the safety and soundness of the Bank.

- The Board’s required role in talent management is particularly expansive. The Bank’s Board is required to hire the Bank CEO, presumably as opposed to the Board of the parent. Moreover, the Bank’s Board is required to approve the hiring of all the CEO’s direct reports. The Board must also approve all decisions related to the selection, removal and compensation of the CRE and CAE. In addition, the Board is required to establish reliable succession plans for the foregoing individuals, and to oversee the talent development, recruitment, and succession planning processes for independent risk management and internal audit, and for individuals reporting to individuals who report directly to the CEO.

- The Board is expected to conduct an annual self-assessment that includes an evaluation of its effectiveness in meeting the minimum standards.

- The Board should establish a formal ongoing training program for the independent directors that includes training on complex products, services, lines of business, and significant risks, and applicable laws regulations, and supervisory requirements.

- The OCC requests comment on the composition of a Bank’s Board, including whether the minimum number of independent directors required under the Guidelines is the appropriate number, whether there are other standards the OCC should consider to ensure the Board’s composition is adequate to provide effective oversight of the Bank, and whether there is value in requiring the Bank to maintain its own risk committee and other committees, as opposed to permitting the Bank’s board to leverage the parent’s Board committees.
ADDITIONAL ISSUES

The NPR maintains that “one of the primary fiduciary duties of a Bank’s Board is to ensure that the institution operates in a safe and sound manner.” This statement is troublesome in multiple respects. First, it provides that the Board has an obligation to “ensure” a result, which is a standard that is beyond existing law and often achievability. Second, there may be an implicit suggestion that this “fiduciary duty” is owed to someone, e.g., the OCC, other than the shareholder(s). Third, the statement suggests that there is a separate fiduciary duty beyond the two widely recognized duties of loyalty and care.

The NPR maintains that the Bank’s Board “[M]ust ensure . . . that parent company decisions and ‘complex banking structures’ do not jeopardize the safety and soundness of the bank.” It is not clear how this could be accomplished.

The NPR suggests that independent risk management and internal audit would find it “useful” to engage the services of external experts, which can be read to suggest that the OCC expects Banks to do so.

* * *

The OCC also proposes in the NPR to apply Part 30 of the OCC’s rules, 12 CFR Part 30, including Appendices A through C, to Federal savings associations, and consequently removing Part 170 as unnecessary.


4. One other regulatory trend that would be continued is the absence of any differentiation based on size, complexity or any other factor once the $50 billion asset size (designated in Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act) is exceeded.


7. According to the NPR, these expectations generally are: (i) for the Board to preserve the “sanctity of the charter” by ensuring that the institution operates in a safe and sound manner; (ii) to have a well-defined personnel management program that ensures appropriate staffing levels, provides for orderly succession, and provides for compensation tools to appropriately motivate and retain talent that does not encourage imprudent risk taking; (iii) to define and communicate an acceptable risk appetite across the organization; (iv) to have reliable oversight programs, including the development and maintenance of strong audit and risk management functions; and (v) for the Board to provide credible challenges to Bank management’s decision-making.

8. As noted in the NPR, entities are included in the OCC’s Large Bank program based on asset size and consideration of factors that affect the institution’s risk profile and complexity. See Comptroller’s Handbook for Bank Supervision Process at 3 (Sept. 2007).

9. These standards may relate to (i) internal controls, information systems, and internal audit systems, in accordance with section 36 of the FDI Act, 12 U.S.C. § 1831m; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate exposure; (v) asset growth; (vi) asset quality; (vii) earnings; (viii) compensation, fees, and benefits, in accordance with Section 39(c), 12 U.S.C. § 1831p-1(c); (ix) stock valuation and (x) such other operational and managerial standards as the OCC determines to be appropriate. 12 U.S.C. § 1831p-1(a).

10. If a standard is issued by regulation, the OCC must require the institution to submit a plan. 12 U.S.C. § 1831p-1(e)(1)(A). The OCC issued the Framework as Guidelines to allow itself flexibility to determine whether to require a plan given the specific circumstances of the non-compliance.


13. Although not clearly specified in the Guidelines, the same approach would presumably be applied in determining whether a banking organization with a national bank subsidiary had IDI subsidiaries that had aggregate assets of $50 billion.

14. Consistent with the OCC’s authority under section 39, the Guidelines apply only to IDIs. The OCC is considering whether to apply the Guidelines to uninsured entities, such as trust banks and Federal branches or agencies of foreign banks.

15. Third-party relationship have recently been a focus of the OCC. On October 13, 2013, the OCC released guidance applicable to national banks and Federal savings associations for assessing and managing risks associated with third-party relationships. See OCC BULLETIN 2013-29 (Oct. 13, 2013).
ENDNOTES CONTINUED

17 In this regard, the OCC establishes an expectation that the Global Systemically Important Banks it supervises will be largely compliant with the BCBS’s principles for effective risk data aggregation and reporting by the beginning of 2016, and that other Banks subject to the Guidelines should make an effort to bring their practices into alignment with the principles.

18 The Guidelines characterize “risk culture” as the shared values, attitudes, competencies, and behaviors present throughout the Bank that shape and influence governance practices and risk decisions.

19 See 77 FR 29458 (May 17, 2012).

20 The Guidelines define “risk profile” as a point-in-time assessment of the Bank’s risks, aggregated within and across each relevant risk category, using methodologies consistent with the Bank’s risk appetite statement. The NPR establishes expectations that (i) independent risk management will prepare the assessment with input from front line units, (ii) the CEO, in conjunction with the board, will ensure the assessment is comprehensive, understand its underlying assumptions, and recommend appropriate changes, and (iii) internal audit will independently assess the assessment’s comprehensiveness and challenge assumptions. Examiners will assess the integrity of the process used to prepare the assessment.

21 Federal savings associations must also comply with additional existing regulatory requirements.

22 The Guidelines alternatively permit the Bank’s audit committee to oversee the CAE’s day-to-day activities.
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