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October 30, 2009

Federal Reserve Issues Proposed Guidance on Sound Incentive Compensation Policies

On October 22, 2009, the Federal Reserve ("the Fed") issued proposed guidance designed to help ensure that incentive compensation policies at banking organizations do not encourage excessive risk-taking or undermine the safety and soundness of the organization. The Fed expects all banking organizations to immediately review their incentive compensation arrangements with the proposed principles in mind and take corrective actions where needed. In connection with this guidance, the Federal Reserve is also commencing two supervisory initiatives to promote progress by the banking industry in the development and implementation of sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the banking industry. This letter summarizes the Fed's proposed guidance along with an overview of the supervisory initiatives.

Federal Reserve Proposed Guidance

The Fed's guidance is to be applied to incentive compensation arrangements for:

- Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
- Individual employees whose activities may expose the firm to material amounts of risk (e.g., traders with large position limits relative to the firm's overall risk tolerance); and,
- Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the firm to material amounts of risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's risk).

The guidance is based on three key principles, which are consistent with the Financial Stability Board's Principles for Sound Compensation Practices and related Implementation Standards issued in April and September 2009, respectively:

Principle #1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not provide employees with incentives to take excessive risks on behalf of the banking organization. Arrangements should not only be balanced in design, but also implemented so that actual payments vary based on risks or risk outcomes.

- Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.
  - Forms of risk include credit, market, liquidity, operational, legal, compliance, and reputational.
- An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.
  - Examples include factoring risk into the determinations of the size and payout of an incentive award, deferring incentive payouts with deferrals subject to ongoing performance, applying longer performance periods, and flattening the incentive payout curve for higher levels of performance.
- The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees – including the substantial differences between senior executives and other employees – as well as between banking organizations.
- Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.
  - The payment of severance or accelerated payment of deferred compensation at termination without regard to risk or risk outcomes may cause inappropriate risk-taking by employees.
- Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.

Principle #2: Compatibility with Effective Controls and Risk Management

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

- Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk management and other functions.
  - For example, the organization's policies and procedures should (i) identify and describe the role(s) of those involved in the design, implementation, and monitoring of incentive compensation arrangements, (ii) identify the sources of risk and establish appropriate controls to govern these risks, and (iii) identify those required to approve new arrangements or modify existing ones.
- Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking.

  - This could include (i) reviewing the types of risks associated with the activities of employees covered by an incentive arrangement, (ii) approving the risk measures used in risk adjustments and performance measures, and (iii) analyzing risk-taking and risk outcomes related to incentive payments.

- Compensation for employees in risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.
  - To help preserve independence, incentive compensation arrangements for risk management and control personnel should not be tied predominantly to the financial performance of the business unit(s) that they review.
- Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.

Principle #3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices.

- The board of directors of a banking organization should actively oversee incentive compensation arrangements.
  - This would include (i) the review and approval of the overall goals and purposes of the firm's incentive compensation system and (ii) direct responsibility for the approval of incentive arrangements for senior executives.
- The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.
  - This review should include look-back and forward-looking analyses.
- The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.
- A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.
- Large, complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.
  - Such an approach should allow the organization to effectively (i) identify employees eligible for incentive compensation and those who may expose the organization to risk, (ii) identify the types and time horizons of risks from the activities of these employees, (iii) assess the potential for the performance measures used to encourage excessive risk-taking, (iv) include incentive design measures that mitigate risk as needed, (v) communicate to employees the ways incentive awards and payouts are adjusted for risk, and (vi) monitor and modify incentive compensation programs for these employees as needed to appropriately align the pay-to-risk profile.

– Regional and community banking organizations should develop policies, procedures, and systems that are appropriate for their size and complexity.

The term "board of directors" in the Fed's proposed guidance refers to the board members with primary responsibility for overseeing an organization's incentive compensation system. Therefore, this term may refer to a compensation committee or another committee designated by the full board to oversee incentive compensation arrangements.

The Fed expects all banking organizations to evaluate their incentive compensation arrangements and related risk management, control, and corporate governance processes and immediately address deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in the guidance, do not encourage excessive risk-taking, and do not pose a threat to the safety and soundness of the organization.

Supervisory Initiatives

In addition to the proposed guidance, the Fed is commencing two supervisory initiatives to ensure that banking organizations are incorporating the proposed principles into incentive compensation practices. The purpose of the supervisory action is to address the "first mover" problem that may make it difficult for individual banking organizations to act alone in addressing incentive compensation issues. The first initiative will be applicable to large, complex banking organizations. The second will apply to community and regional banking organizations. The Fed's rationale for special supervisory attention over large banking organizations is that they are significant users of incentive compensation arrangements and the adverse effect of flawed approaches at these institutions are more likely to have adverse effects on the broader financial system.

Large, complex banking organizations (LCBOs)

There are currently 28 organizations that qualify as an LCBO. The Fed will conduct a formal horizontal review of incentive compensation arrangements at these organizations with the following objectives in mind:

1. Enhance supervisory understanding of the details of current practices, as well as the steps taken or proposed to be taken by organizations to improve the balance of incentive compensation arrangements;
2. Assess the strength of controls and whether actual payouts under incentive compensation arrangements are effectively monitored relative to actual risk outcomes;
3. Understand the role played by the boards of directors, compensation committees, and risk-management functions in designing, approving, and monitoring incentive compensation systems; and
4. Identify emerging best practices through comparison of practices across organizations and business lines.

As part of this review, each LCBO will be expected to provide the Fed with information and documentation that clearly describes:

- The structure of the organization's current incentive compensation arrangements;
- The existing processes used by the organization to oversee these arrangements and help ensure that they do not encourage employees to take excessive risks; and
- The organization's plans, including relevant timetables, for improving the risk-sensitivity of incentive compensation arrangements and related risk management, controls, and corporate governance practices.

Community and regional banking organizations

There are over 6,800 non-LCBO banking organizations. The Fed will review the incentive compensation arrangements at these organizations as part of the regular, risk-focused supervisory process. Supervisory findings will be included in the relevant report of examination or inspection, communicated to the organization, and incorporated, as appropriate, into the organizations supervisory ratings. The Fed may take enforcement action against a banking organization if its incentive compensation arrangement or related risk management, control, or governance processes pose a risk to the safety and soundness of the organization and the organization is not taking prompt and effective measures to correct the deficiencies.

Conclusion

The Fed's proposed guidance is subject to a 30-day comment period ending November 27, 2009. However, as mentioned above, the Fed expects banking organizations to review their incentive compensation arrangements immediately based on the proposed guidance. Though the proposed guidance is intentionally not rules-based, it does provide banking organizations with direction on how to comply with the guidance through suggestions and examples. It also serves as a framework from which all public companies can review and assess their incentive compensation programs for material risks stemming from these programs, which may become a potential disclosure item under the SEC's proposed changes to the proxy disclosure rules.[1] A link to the Federal Register notice with the full text of the proposed guidance can be found at http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm.

The Fed will continue to review and update the guidance as appropriate to incorporate best practices that emerge from these initiatives, which will provide banking organizations with better direction in the future. In addition, the Fed plans to prepare a report on trends and developments in compensation practices at banking organizations after the conclusion of 2010.

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General questions about this letter can be addressed to David Yang in our Chicago office at (312) 894-0074 or dkyang@fwcook.com. Copies of this summary and other related materials are available on our website at www.fwcook.com.

[1] See our alert letter "SEC Proxy Disclosure Rules and Corporate Governance Revisions" dated July 14, 2009