

**BANKING LAW ALERT**

**October 29, 2009**

There have been a number of developments since the Obama Administration issued its proposals in June for an overhaul of the existing financial regulatory framework. With the debate over health care reform demanding most of the attention in Washington, the Federal Reserve and the House Financial Services Committee have made headway on regulatory reforms. This Alert highlights several developments in the past few weeks.

*This Alert is provided to Clients and friends of the Firm. If you have questions regarding any of the items discussed, please contact one of the following attorneys:*

<i>* Robert Smith</i>	<i>* Bryan Duke</i>
<i>(501) 370-1559</i>	<i>(501) 370-1560</i>
<i>rsmith@fridayfirm.com</i>	<i>bduke@fridayfirm.com</i>

**Federal Reserve Issues Executive Compensation Guidance**

On October 22<sup>nd</sup>, the Federal Reserve Board issued proposed guidance designed to insure that incentive compensation practices at banking institutions do not threaten the safety and soundness of those firms. The guidance is issued in recognition that troubles at a number of financial firms are at least partly the result of inappropriate compensation practices contributing to excessive risk taking and financial instability.

The proposal includes two initiatives. The first applies to the twenty-eight (28) largest, complex banking organizations [referred to as "LCBO(s)"]. The Fed will review each firm's incentive compensation policies and practices to determine whether they inappropriately encourage excessive risk taking. The Fed will assist each bank in adopting appropriate policies in response to the findings of this review, which will then become a part of the supervisory expectations for each firm to be monitored for continued compliance. With respect to smaller regional and community organizations, the Fed will review compensation practices only as part of the regular, risk-focused examination process. Importantly, for both LCBOs and smaller institutions, the findings from these reviews will be incorporated into the bank's supervisory ratings.

**What is covered?**

Although the guidance does not define "incentive compensation", the Fed appears to apply a broad definition essentially covering any compensation arrangement that attempts to "encourage actions that result in greater revenue or profit" for the institution. The Fed's stated intention is to strike an appropriate balance between the activities earning additional compensation and the appropriateness of risks attendant to those activities.

### Who is covered?

The guidance applies to all banking organizations supervised by the Federal Reserve, including bank holding companies and state member banks. At the individual level, the guidance will generally apply to incentive compensation arrangements for: (1) senior executives; (2) individual employees, including non-executives, whose activities may expose the firm to material amounts of risk; and (3) 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.

The principles outlined are intended to provide employees with incentives that do not encourage excessive risk-taking beyond the firm's ability to effectively identify and manage risks. The Fed repeatedly emphasizes the necessity of employing strong corporate governance practices, including active oversight by the organization's board of directors.

Fortunately for community banks, the Fed confirms that the reviews and policies implemented by a small banking organization that uses incentive compensation on a limited basis will be substantially less extensive, formalized and detailed than those at larger firms. The extent of these reviews remains to be seen.

### What is not included?

Although some commentators suggested establishing rigid formulas and compensation limits for all banking organizations (*e.g.*, caps on pay; requiring that some minimum percentage of incentive compensation be paid in stock), the guidance does not impose strict standards but requests input from the public to assist in developing best practices in this area. While the absence of pay limitations is a relief, the Fed's approach creates significant uncertainty for the time being.

### What to do?

The Fed will require that all banks evaluate their incentive compensation arrangements and related risk management, control and corporate governance processes and address any deficiencies that are inconsistent with safety and soundness. The Fed specifically expects banking organizations to (i) have policies and procedures that identify and describe the roles of personnel involved in incentive compensation arrangements, identify the source of significant risks relating to those arrangements, establish appropriate controls governing those risks, and identify the individual whose approval is necessary for the establishment or modification of incentive compensation arrangements; (ii) create and maintain sufficient documentation to permit an audit of the organization's processes for incentive compensation arrangements; (iii) have any material exceptions or adjustments to the incentive compensation arrangements established for senior executives approved and documented by its board of directors; and (iv) have its board of directors receive and review, at least annually, an assessment by management of the effectiveness of the design and operation of the organization's incentive compensation system.

As a practical matter, non-public institutions should do the following:

- (1) Consider the relationship between the firm's compensation policies and the various risks that the bank is subject to (e.g., risks in the areas of credit, liquidity, operations, legal, regulatory compliance and reputation);
- (2) Ensure that the institution's board of directors is directly involved in both developing overall compensation policies and approving specific compensation decisions for management-level employees;
- (3) Consider whether a separate compensation committee comprised of independent directors is appropriate for the institution; and
- (4) Review the appropriateness of any existing "golden parachute" arrangements.

The Fed will accept public comments for a period of 30-days after the publication of the guidance in the federal register and has specifically requested comments on whether the guidance would impose undue burdens on regional and small banking organizations.

### **Consumer Financial Protection Agency Moves a Step Closer to Approval**

As part of its package of regulatory reform, the Obama administration proposed creation of the Consumer Financial Protection Agency (the "CFPA"). The purpose of the CFPA is to consolidate the existing regulatory regime for financial services products marketed to consumers. The legislation recently passed the House Financial Services Committee by a vote of 39 to 29.

The bill gives a broad range of authority to the CFPA to regulate activities of both banks and non-banks. The original draft of the bill required that each banking institution offer "plain vanilla" products (to be designated by the CFPA) alongside more complex financial products, and would have imposed vague standards for communications with consumers. Fortunately for the banking industry, and in no small measure a result of a strong lobbying effort by the American Bankers Association, those provisions were deleted from the legislation approved by the Committee. Most importantly, amendments to the bill have excluded examination authority of the CFPA over banks and institutions with \$10 billion or less in assets. Those organizations will be examined by their primary federal regulator for compliance with all CFPA rules. All financial institutions will, however, be subject to CFPA rules and regulations regardless of size.

The CFPA Act would also eliminate federal preemption of all state consumer protection statutes, meaning that state regulatory agencies could directly enforce those rules upon national banks.

## **TARP: Round 2**

On October 21<sup>st</sup>, President Obama announced a new effort to provide capital to community banks in order to improve access to credit for small businesses. You may recall that under the original Capital Purchase Program banks were allowed to apply for capital infusions at a dividend rate of 5% for the first five years, increasing to 9% thereafter. Under the proposal, banks with total assets under \$1 billion may have access to capital at a dividend rate of 3% after submitting a plan detailing how the capital will allow them to increase lending to small businesses. Organizations receiving capital will be required to submit quarterly reports regarding business lending activities. A major criticism of the initial Capital Purchase Program was the perception that banks were hoarding capital rather than deploying TARP investments to increase business lending.

Subject to approval of the applicable federal bank regulator, participants will be eligible to receive new capital at an initial dividend rate of 3%, compared to the 5% rate available under the original Capital Purchase Program. Banks may be eligible for capital in an amount up to 2% of risk-weighted assets.

The Treasury is currently working to finalize terms of the program to best support small business lending, including the amount of capital available to participating institutions and the treatment of existing Capital Purchase Program participants that wish to replace existing capital with investments under the new program.

As part of this initiative, the administration also intends to make capital available to community development financial institutions ("CDFI") at a rate of 2% for up to eight years to encourage and support small business lending in underserved rural and urban communities. Institutions desiring to participate in the program that have not yet been certified as CDFIs will be given an expedited review by the CDFI fund.

## **Board of Director Training Presentations**

As economic conditions have remained turbulent over the past year, our firm has advised a number of companies and Boards of Directors regarding compliance with corporate fiduciary duties. The recent uproar over executive compensation at financial firms and the resulting federal guidance discussed above has heightened the sensibilities of shareholders, creditors and regulators to these issues, and enhanced the importance for Boards to employ processes and internal procedures evidencing compliance with these duties.

In response to this, we have prepared a presentation updating Boards on their fiduciary obligations, including recent caselaw developments. Our presentation focuses on how those duties are implicated in various situations, including executive compensation decisions, mergers and acquisitions, corporate indemnification obligations, and capital raising transactions.

We are offering to present this discussion to clients and colleagues of our firm at no cost. We can tailor the materials to fit within your time schedule (typically 30 to 45 minutes). If you are interested in scheduling a time for us to meet with your Board, please contact either Robert Smith (501-370-1559; [rsmith@fridayfirm.com](mailto:rsmith@fridayfirm.com)) or Bryan Duke (501-370-1560; [bduke@fridayfirm.com](mailto:bduke@fridayfirm.com)).

*This Friday, Eldredge & Clark, LLP publication should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own attorney on any specific legal questions you may have.*

*If you would prefer to receive future publications by email, please send your request to [cwalker@fridayfirm.com](mailto:cwalker@fridayfirm.com). Thank you.*