SIMPSON THACHER

MEMORANDUM

Federal Reserve Issues Proposed Incentive Compensation Guidance for All Banking Organizations

November 2, 2009

OVERVIEW

On October 22, 2009, the U.S. Board of Governors of the Federal Reserve System ("Federal Reserve") issued Proposed Guidance on Sound Incentive Compensation Policies (the "Guidance"). The Guidance is intended to ensure that banking organizations' incentive compensation arrangements do not undermine the safety and soundness of such organizations (i.e., that these policies do not encourage employees to take excessive risks).

The Guidance also announces that the Federal Reserve is immediately undertaking two supervisory initiatives (the "Initiatives") that are intended to identify unsafe compensation practices at banking organizations and move such organizations towards risk-management systems, controls or other practices that it believes would assist in implementing safe and sound compensation practices.

The Guidance generally applies to all banking organizations supervised by the Federal Reserve, not just to those organizations that have received assistance under TARP. These banking organizations include U.S. bank holding companies, state member banks, Edge and agreement corporations, and the U.S. operations of foreign banks with a branch, agency or commercial lending company subsidiary in the U.S. (any of the foregoing, a "Banking Organization").

The Guidance will become effective on the date it is adopted in its final form, which may be months away. The final Guidance may also differ substantially from the proposed Guidance. The Federal Reserve has invited public comment on the Guidance and the Initiatives, which comments are due by November 27, 2009. However, the Federal Reserve expects all Banking Organizations to immediately begin evaluating their incentive compensation arrangements and related risk management, control and corporate processes and addressing deficiencies in these arrangements or processes that are inconsistent with the Banking Organization's safety and soundness.

Described briefly, the Guidance provides for the following:

- Rules for Incentive Compensation Arrangements of Certain Groups of Employees at All Banking Organizations. The Guidance is applicable to incentive compensation arrangements for:

  1) senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;

2) individual employees, including non-executive 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

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, even if no individual employee is likely to expose the firm to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

These executive and non-executive employees are collectively referred to as "employees."

The term "incentive compensation" refers to "that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is tied to, continued employment (e.g., salary)."

- Supervisory Initiatives. The Federal Reserve expects all Banking Organizations to immediately begin evaluating their incentive compensation arrangements and related risk management, control and corporate processes, and addressing deficiencies in these arrangements or processes that are inconsistent with safety and soundness. The Federal Reserve is commencing the following two Initiatives:
    - A "horizontal review" of incentive compensation practices at 28 unidentified "large complex banking organizations" ("LCBOs"),[1] to be led by Federal Reserve staff and the relevant Federal Reserve Bank supervisors. Each LCBO will be expected to provide the Federal Reserve with its plans, including relevant timetables, for improving the risk-sensitivity of its incentive compensation arrangements and related risk management, controls and corporate governance practices (including documentation that clearly describes the structure of, and existing processes used to oversee, the incentive compensation arrangements). The Guidance states that these reviews are designed to achieve four objectives: (1) enhance the Federal Reserve's supervisory understanding of the details of current practices and steps to be taken to improve the balance of incentive compensation arrangements; (2) assess the strength of controls and whether

[1] As a general matter, the Federal Reserve has identified LCBOs as having significant on- and off-balance sheet risk exposures, offering a broad range of products and services at the domestic and international levels, being overseen by multiple supervisors in the United States and abroad, and participating extensively in large-volume payment and settlement systems. The Federal Reserve has stated that such banking organizations are exposed to the potential for swift and dramatic changes in their risk profile and more rapid transmission of financial shocks. The Guidance states that to be designated an LCBO, a banking organization must meet specified criteria for being considered a significant participant in at least one key financial market. Such criteria would look to, among other things, an LCBO's broader U.S. capital market activity, including underwriting, securitization, derivatives and trading; its retail financial services; and its involvement in international financial markets. The Federal Reserve stated in its October 22, 2009 press release regarding the Guidance that it believes this definition covers 28 large complex banking organizations, but does not specifically identify them.

actual payouts under incentive compensation arrangements are effectively monitored relative to actual risk outcomes; (3) understand the role played by 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 Banking Organizations and business lines.

- A review of incentive compensation practices at non-LCBO Banking Organizations as part of the risk-focused examination process for these organizations. For regional and community Banking Organizations, reviews will be conducted as part of the evaluation of the organization's risk management, internal controls and corporate governance during the regular examination process,[2] and should be tailored to reflect the scope and complexity of the organization's activities and prevalence and scope of its incentive compensation arrangements.

The findings under these Initiatives will be included in the relevant report of examination or inspection, communicated to the Banking Organization, and incorporated, as appropriate, into its supervisory ratings.[3] The Federal Reserve may take enforcement action against a Banking Organization if its incentive compensation arrangements or related risk management, control or governance processes pose a risk to the safety and soundness of the organization and it is not taking prompt measures to correct the deficiencies, including requiring the Banking Organization to develop a corrective action plan acceptable to the Federal Reserve.

- Three Principles of Safety and Soundness of Incentive Compensation Arrangements. The Guidance proposes three principles of safety and soundness of incentive compensation arrangements, and related policies and procedures, at a Banking Organization: (1) balanced risk-taking initiatives; (2) compatibility with effective controls and risk management; and (3) strong corporate governance.

  Principle 1: Balanced Risk-Taking Initiatives:

  - Balance risk and financial results in a manner that does not provide employees incentives to take excessive risks on behalf of the Banking Organization. The Guidance states that an incentive compensation arrangement is "balanced" when the amounts paid to an employee appropriately take into account the risks, as well as the financial benefits, from the employee's activities and the impact of those activities on the Banking Organization's safety and soundness. The

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[2] For example, reviews at bank holding companies with total consolidated assets of $5 billion or less will be conducted in accordance with the risk-focused supervision program for those organizations. Generally, such supervision entails a full scope investigation that may be satisfied with a more targeted on-site review, supplemented by other information sources.

[3] For example, supervisory findings under the Guidance for bank holding companies should be incorporated into the assessment of the appropriate subcomponents for a bank holding company's "Risk Management" rating component in the "RFI," or the rating with respect to Risk Management, Financial Condition, and Impact.

Guidance provides, as an example, two employees who generate the same amount of "short-term revenue or profit" (term not defined), but one of those employee's activities create "materially larger risks" for the organization than the other employee—and states that the employee who generates more risk should not receive as much incentive compensation as the employee whose activities are not as risky. The Guidance also focuses on the performance measures used in the incentive compensation arrangement, advising that incentive compensation payments that are determined based on performance measures that are "only distantly linked" to the employee's activities (e.g., for most employees, firm-wide profit), and that are relatively small based on the employee's total compensation package, are less likely to cause the employee to take excessive risks. Finally, the Guidance advises that a balanced incentive compensation arrangement provides that employees have less incentive to avoid risky activities if substantially all of their potential incentive compensation would be paid even when risk outcomes are materially worse than expected.

- In assessing whether incentive compensation arrangements are balanced, 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. The Guidance identifies credit, market, liquidity, operational, legal, compliance and reputational risks as current and potential risks to be considered, including risks that may have a low probability of being realized, but if realized would have highly adverse effects on the organization ("bad-tail risks"), and the cost and amount of capital and liquidity needed to support risks being taken. The Guidance recommends using "reliable quantitative risk measures" wherever available. If such measures are not available, and judgment plays a significant role in the design or operation of an incentive compensation arrangement, the Guidance advises that strong internal controls and retroactive monitoring of incentive compensation payments relative to actual risk outcomes are particularly important. The Guidance also recommends a "scenario analysis" of incentive compensation arrangements, which involves the evaluation of payments on a forward-looking basis based on a range of performance levels, risk outcomes and the levels of risks taken.

- By adding or modifying features that cause the incentive compensation amounts ultimately received by employees to appropriately reflect risks and outcomes, an unbalanced arrangement can become a balanced arrangement. The Guidance sets out four methods that the Federal Reserve believes currently are often used to make compensation more sensitive to risk. These methods are:

    - Risk Adjustment of Awards: The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities pose to the Banking Organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.

    - Deferral of Payment (or "Clawbacks"): The actual payout of an award to an employee is delayed significantly beyond the end of the

performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that become clear only during the deferral period. Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, though extensive use of judgment might make it more difficult to execute deferral arrangements in a sufficiently predictable fashion to influence employee behavior. To be most effective, the Guidance advises that the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.

- Longer Performance Periods: The time period covered by the performance measures used in determining an employee's award is extended (e.g., from one year to two years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.
- Reduced Sensitivity to Short Term Performance: The Banking Organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives. The Federal Reserve believes that employees may be "particularly motivated to take excessive risk in order to reach performance targets that are aggressive, but potentially achievable."

- Tailor incentive compensation arrangements to account for differences between employees as well as between Banking Organizations. The Guidance proposes that a single, formulaic approach to incentive compensation arrangements (e.g., spreading payments over a three-year period) may not sufficiently reduce the risks associated with the activities of varying groups of employees. Specifically, it suggests that one group of non-executive employees (e.g., loan originators) may differ significantly from the risk incentives of another group of non-executive employees (e.g., spot foreign exchange traders), just as the payment of one form of incentive compensation (e.g., equity or equity-based awards, such as options) may be more effective in restraining risk-taking of senior executives or other employees whose activities may have a material effect on the overall financial performance of the firm than lower-level employees who are unlikely to believe that their activities will materially affect the firm's stock price. The Guidance proposes the following guidelines for a well-balanced incentive compensation arrangement in this regard:
  - Incentive compensation arrangements for senior executives at LCBOs are likely to be better balanced if they involve a deferral of a substantial portion of the executives' incentive compensation, for a variety of multi-year performance periods, in a way that reduces the amount

received in the event of poor performance, and if such compensation is paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the firm during the deferral period.

- Incentive compensation arrangements for all other employees at Banking Organizations that are paid in the form of equity-based instruments should appropriately take into account the level, nature and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the firm and its stock price.

- 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. The Federal Reserve believes that arrangements that provide for large payments to an employee upon a departure from, or a change in control of, a Banking Organization provide an employee with "significant incentives to engage in undue risk-taking." The Guidance admonishes Banking Organizations to carefully review these arrangements for their impact on the organization's safety and soundness. The Guidance also advises Banking Organizations to re-assess their practice of causing employees who leave the organization to forfeit deferred compensation. This is because the Federal Reserve believes that the practice of "golden handshakes" (i.e., where a new firm compensates an employee for the loss of deferred compensation when the employee departs the old firm), may actually remove the employee's financial exposure to the risk outcomes of the employee's activities at the firm that granted the forfeited deferred compensation.

- Banking Organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risk increases. The Guidance advises Banking Organizations to very clearly communicate to their employees about the key ways in which risks are taken into account in determining the amount of incentive compensation paid, including, where feasible, examples of how compensation payments may be adjusted to reflect projected or actual risk outcomes.

Principle 2: Compatibility with Effective Controls and Risk Management

- 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. To help prevent employees from either evading processes established to achieve balanced incentive compensation or influencing the risk measures or other information used to make the employee's pay sensitive to risk in ways that increase the employee's pay, the Guidance advises that a Banking Organization should:

    - have controls governing the design, implementation and monitoring of incentive compensation arrangements;

- identify personnel, business units and "control units" authorized to design, implement, monitor and approve the incentive compensation arrangements, as well as the sources of significant risk-related inputs into these processes, and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity;
- maintain documentation of these processes sufficient to permit an audit, and to conduct regular internal reviews to ensure these processes are being followed in a manner consistent with its overall framework of compliance monitoring, as well as separately conduct regular audits of the organization's compliance with its established controls relating to incentive compensation arrangements; and
- report all audit results to management and where appropriate, the board of directors; reviews conducted by regional or community Banking Organizations should be tailored to the framework of the organization, as well as the scope and complexity of its activities and use of incentive compensation arrangements.

- Appropriate personnel, including risk-management personnel, should have input into the Banking Organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking. The Guidance advises that Banking Organizations should have policies and procedures that ensure risk-management personnel have an appropriate role in its processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining excessive risk-taking. The Guidance states that risk managers may assist in achieving balanced compensation arrangements by: (1) reviewing the types of risks associated with the activities of employees covered by an incentive compensation arrangement; (2) approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and (3) analyzing risk-taking and risk outcomes relative to incentive compensation 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. The Guidance states that the risk management and control personnel involved in the design and oversight of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. The compensation arrangements for these personnel should be sufficient to attract and retain qualified personnel. However, to preserve the independence of their perspectives, the Guidance advises that the incentive compensation received by these personnel should not be based predominantly on the financial performance of the business units they review. Instead, these personnel should receive incentive compensation based primarily upon the achievement of the objectives of their functions (e.g., adjusted performance or adherence to internal controls).

- 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. The Guidance states that Banking Organizations should track incentive compensation awards and payments, risks taken, and actual outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes. Reports of these results are to be given to appropriate levels of management, which may include the board of directors, and the results are to be taken into account in establishing or modifying incentive compensation arrangements and in overseeing controls to ensure the arrangements do not provide employees incentives to take excessive risks.

Principle 3: Strong Corporate Governance

- The board of directors of a Banking Organization should actively oversee incentive compensation arrangements. The Guidance advises that a Banking Organization's board of directors (or the committee thereof that has primary responsibility for overseeing the incentive compensation system) should actively oversee the development and operation of its incentive compensation systems and related control processes. This includes the review and approval of goals and purposes of the incentive compensation system and ensuring that the compensation system (including performance measures and targets) for business units and individual employees, including the incentive compensation arrangements (and any exceptions or adjustments thereto) of the senior executives of the firm that can expose the firm to significant risk, is designed and operated in a manner that will achieve balance.
- The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements. The Guidance states that boards of directors of Banking Organizations should regularly review the design, and monitor the performance, of the organization's incentive compensation systems by receiving and reviewing, at least annually, data sufficient to be able to determine if the design and performance of the incentive compensation arrangements are consistent with the organization's safety and soundness (including an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the system in providing risk-taking incentives consistent with the organization's safety and soundness). If a Banking Organization is a significant user of incentive compensation arrangements, these reports should also contain reviews of incentive compensation awards and payments relative to the risk outcomes on a backward-looking basis to determine whether its incentive compensation arrangements may be promoting excessive risk-taking, and the board should also consider periodically obtaining and reviewing scenario analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes and the amount of risks taken. Boards should also monitor payments to senior executives and their sensitivity to risk outcomes, including reviewing

both backward and forward-looking scenario analyses for senior executives, and whether clawback provisions (if applicable) have been triggered.

- The organization, composition and resources of the board of directors should permit effective oversight of incentive compensation. The Guidance advised that the board of directors should consider establishing a separate compensation committee, which reports to the full board and is composed solely or predominantly of non-executive directors, that has primary responsibility for overseeing the organization's incentive compensation systems. If the board does not have such a committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. At all LCBOs and large regional Banking Organizations, and at other Banking Organizations where feasible, one or more board members should have a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate for the nature, scope and complexity of the organization's activities. The board may select, compensate and use outside counsel, consultants or other experts with expertise in incentive compensation and risk management, giving due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons and exercising caution to avoid allowing outside parties to obtain undue levels of influence.
- A Banking Organization's disclosure practices should support safe and sound incentive compensation arrangements. The Guidance states that a Banking Organization should provide an appropriate amount of information concerning its incentive compensation arrangements and related risk management, control and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes to encourage employees to take excessive risks. The Guidance states that the Federal Reserve intends to work with the Securities and Exchange Commission to improve disclosures provided by public Banking Organizations, and in connection with the horizontal LCBO review process, intends to conduct a review of its regulatory reporting forms to determine what types of summary-level quantitative information concerning incentive compensation arrangements would be appropriate for the Federal Reserve to collect and make public.
- LCBOs should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements. The Guidance states that LCBOs with large numbers of risk-taking employees engaged in diverse activities should use a systematic approach that uses formalized policies, procedures and systems to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. The Guidance states that such an approach should provide for the organization to:
    - identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include all of the employees (as previously defined);

- o identify the types and time horizons of risks to the organization from the activities of these employees;
- o assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take excessive risks;
- o include measures, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced;
- o communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and
- o monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

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The Federal Reserve has stated that it will review and update the Guidance as appropriate to incorporate best practices that will emerge from the implementation of the Guidance and the findings under the Initiatives. To that end, the Federal Reserve will prepare a report on trends and developments in compensation practices at Banking Organizations after the end of 2010.

This memorandum is only a summary of the Guidance (a copy of which may be obtained at http://edocket.access.gpo.gov/2009/E9-25766.htm). The information contained in this memorandum does not represent, and should not be regarded as, the view of Federal Reserve or any particular client of Simpson Thacher. If you have any questions about the new Guidance or Initiatives referenced in this memorandum, please contact any of the following partners in our Executive Compensation and Employee Benefits department:

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