

# Aldrich Bonnefin & Moore, PLC

## [CORPORATE GOVERNANCE UPDATE]

AUGUST 2010

### REGULATORY REFORM BILL PASSED

The inevitable finally has occurred. On July 1, 2010, the President signed H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act, into law.

The measure will impact financial institutions and the regulatory process for years to come. Included among the provisions of the bill are:

**New consumer protections.** The bill creates the Bureau of Consumer Financial Protection (BCFP). BCFP will take over all consumer regulations, with the exception of the Community Reinvestment Act, and will enforce those rules. However, the BCFP will not examine depository institutions under \$10BB in assets. For those institutions the banking agencies (FDIC, Fed, OCC) will still do examinations. As years go by we might see “tougher” consumer regulations issued by BCFP but nothing right off.

**OTS abolished.** The Office of Thrift Supervision (OTS) is being eliminated. However, the savings association charter is not being abolished. Under the new regime, the OCC will take the reigns in examining federal thrifts, the FDIC will examine state-chartered savings associations, and the Fed will be responsible for regulating savings and loan holding companies.

**New comprehensive disclosures.** The measure requires new comprehensive mortgage disclosures. This may mean that the early Truth in Lending and RESPA disclosures will finally be combined. We can only hope. Other new mortgage

loan regulations are required, to be issued within 18 months and effective 12 months after that.

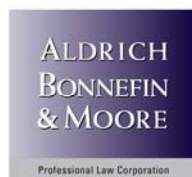
**Collection of monitoring information on small business and other loans.** On loans to minority-owned, women-owned and small businesses, lenders will be required to collect and report the race, sex and ethnicity of the principal owners of the business. HMDA data collection will also be revised.

**Restrictions on investment activities.** The bill requires regulators to implement regulations for banks and their affiliates to prohibit proprietary trading, investment in and sponsorship of hedge funds and private equity funds. The bill also places limits on relationships with hedge funds and private equity funds. Regulations are to be developed after a study by the newly created Financial Stability Oversight Council.

**Payment, clearing and settlement supervision.** The bill establishes systemically important clearing, payments and settlements systems. It gives broad discretion to the federal regulators to determine what measures are necessary to ensure that these systems operate in a sound manner.

For a detailed summary of the Reform Act, visit our website at [www.abmlawfirm.com](http://www.abmlawfirm.com), and click on the “Dodd-Frank Act 2010” button. In addition, we will be presenting hand-outs on the various topics covered by the Reform Act for BCG members at the BCG Monthly Telephone Briefings on the following dates:

- August 20: Agency reorganization, corporate governance and securities.
- September 17: Bureau of Consumer Financial Protection and Consumer Finance.



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- October 15: Payment, Clearing and Settlement Rules and other operations issues.

BCG members and our other clients are encouraged to contact us directly for particular questions regarding the Reform Act.

## AGENCIES ISSUE INCENTIVE COMPENSATION GUIDANCE

On June 21, the federal banking agencies issued final guidance (“Guidance”) on incentive compensation arrangements requiring institutions to take into account risk and safety and soundness practices for their incentive compensation practices. The Federal Reserve issued proposed guidance in late 2009, and the other agencies have opted to join in the issuance of the final version.

The Guidance only applies to the payment of “incentive compensation,” generally meaning compensation that is tied to achievement of one or more metrics (e.g., sales, income, etc.), and does not include salary and 401(k) contributions. Incentive compensation includes severance and deferred compensation arrangements. However, small institutions (referred to in the Guidance is “smaller banking organizations”) with only firm-wide profit-sharing or bonus plans based on the institution’s profitability will not be considered significant users of incentive compensation arrangements if the plan covers all or most employees. The Guidance uses the term “smaller banking organizations” to refer to banking organizations that are not large banking organizations under the relevant agency’s standards.

Under the Guidance, the agencies expect institutions to regularly review their incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review the risk management, control and corporate governance processes related to these arrangements.

According to the Guidance, in order to be consistent with safe and sound practices incentive compensation arrangements should:

- Provide employees incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk management; and
- Be supported by strong corporate governance, including active and effective oversight by the institution’s board of directors.

The Guidance details several types of risk that can be posed by employees’ activities such as credit, market, liquidity, operations, legal, compliance and reputational risks. For small institutions, the Guidance could especially impact executives as well as loan production staff. The Guidance offers certain methods that can be used to reduce and manage risks posed by incentive compensation practices, such as:

- Risk adjustment of awards based on the amount of risk posed by the employee;
- Deferral of payment, to allow for the realization of the risks;
- Longer performance period, also to allow for the realization of risk outcomes; or
- Reduced sensitivity to short-term performance, by focusing more on long-term performance.

The Guidance falls short, however, on making specific recommendations for specific types of employees.

The Guidance also requires that controls be established to ensure the effectiveness of incentive compensation practices (for small institutions, this can be incorporated in overall compliance monitoring), including the involvement of risk management personnel in the establishment of incentive compensation practices. Finally, the Guidance emphasizes the importance of strong corporate governance, including active and effective oversight by the board of directors. It specifies that boards of directors are expected (through board composition, training, or outside parties such as attorneys and consultants) to stay abreast of, and possess expertise in, developments in, and management of, incentive compensation practices and the risks posed by such practices.

The Guidance does recognize, however, that the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to, and will vary greatly based on, the size, complexity, business strategy and risk tolerance of each institution.

The Guidance has no effective date and was issued under the umbrella of safety and soundness, meaning that institutions are expected to immediately comply as a safe and sound practice. Institutions should also expect heightened scrutiny of incentive compensation practices in upcoming examinations.

On a related note, new executive compensation requirements were included in the new Dodd-Frank Act for publicly traded institutions.