Client Update
Basel Committee 2015 Corporate Governance Principles

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On July 8, 2015, the Basel Committee on Banking Supervision ("Basel Committee") issued revised guidelines on corporate governance principles for banks ("2015 Principles").[1] The 2015 Principles update the Basel Committee's 2010 principles ("2010 Principles") for promoting sound corporate governance practices at banking organizations.[2]

We believe it is a worthwhile exercise for U.S. banking organizations to benchmark current practices against the 2015 Principles. Foreign banking organizations required to establish U.S. intermediate holding companies under the Federal Reserve Board's ("Federal Reserve") enhanced risk management standards adopted under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Enhanced Prudential Standards") also may find it useful, given that their U.S. operations will need to satisfy new risk management and governance requirements.[3] In all cases, benchmarking could be a useful step

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[1] Basel Committee on Banking Supervision, Bank for International Settlements, Guidelines: Corporate governance principles for banks (Jul. 2015), http://www.bis.org/bcbs/publ/d328.pdf (hereinafter, "2015 Principles").

[2] Basel Committee on Banking Supervision, Bank for International Settlements, Principles for enhancing corporate governance (Oct. 2010) (Revised Jul. 2015), www.bis.org/publ/bcbs176.pdf. The Basel Committee published initial guidance on corporate governance practices for banking organizations in 1999, with revised principles in 2006. Basel Committee on Banking Supervision, Bank for International Settlements, Enhancing corporate governance for banking organizations (Feb. 2006), http://www.bis.org/publ/bcbs56.pdf. Like its predecessors, the 2015 Principles draw from the corporate governance principles published by the Organisation for Economic Co-operation and Development ("OECD"). *See* 2015 Principles ¶ 4. We note that the OECD is also expected to publish revised principles in September 2015. *See* OECD.org, OECD Principles of Corporate Governance, http://www.oecd.org/corporate/oecdprinciplesofcorporategovernance.htm (last visited Jul. 31, 2015).

[3] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17240 (Mar. 27, 2014) (codified, in part, at 12 C.F.R. pt. 252).

to demonstrate to a banking organization's board and regulators a proactive approach to achieving top-end risk management and governance practices. In addition, we discuss below the implications of the 2015 Principles for any banking organization subject to the Enhanced Prudential Standards or the Office of the Comptroller of the Currency's ("OCC") heightened prudential standards ("OCC Guidelines").[4] This Client Update (1) provides context for the 2015 Principles, (2) gives an overview of the 2015 Principles, (3) summarizes key industry comments, (4) reviews what did and did not change in the 2015 Principles and (5) provides a few key takeaways for banking organizations, including a benchmarking template in Annex 2.

I. CONTEXT FOR THE 2015 PRINCIPLES

The Basel Committee revised the 2010 Principles to reflect corporate governance developments in the financial services industry since the issuance of the 2010 Principles, including the Financial Stability Board's 2013 series of peer reviews and resulting peer review recommendations.[5] The 2015 Principles (1) expand the responsibilities of boards of directors, particularly with respect to overseeing the implementation of effective risk management systems, (2) further define the elements of a robust risk governance framework, including with respect to the responsibilities of business units, risk management teams and internal audit (the so-called "three lines of defense"), (3) provide guidance for bank supervisors in evaluating the processes used by banking organizations to select board members and senior management and (4) review appropriate compensation structures that convey acceptable risk-taking behavior and reinforce sound risk culture.

The 2015 Principles are largely consistent with the consultative version the Basel Committee issued in October 2014 ("2014 Consultative Version").[6] However, as we discuss in detail below, the final version appears responsive to certain industry comments, including, for example, with respect to the demarcation

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[4] Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches, 79 Fed. Reg. 54517 (Sept. 11, 2014) (codified at 12 C.F.R. pt. 30, App. D) (hereinafter, "OCC Guidelines").

[5] 2015 Principles ¶ 10.

[6] Basel Committee on Banking Supervision, Bank for International Settlements, Consultative Document, Guidelines: Corporate governance principles for banks (Oct. 2014), www.bis.org/publ/bcbs294.pdf.

between the duties of the board of directors (or "board") versus senior management.[7]

The 2015 Principles generally are consistent with, but more comprehensive and prescriptive than, the Enhanced Prudential Standards and OCC Guidelines. Although the Basel Committee frameworks are not binding on U.S. banking organizations, the U.S. federal banking agencies are active participants in Basel Committee deliberations and likely consider the 2015 Principles "best practices" for banking organizations under their supervision and may cite the 2015 Principles in the supervisory and exam contexts.

II. OVERVIEW OF THE 2015 PRINCIPLES

The 2015 Principles set forth 13 principles addressing the following topics:

- board responsibilities, qualifications and structure;
- senior management responsibilities;
- governance in multi-tiered organizations,
- risk management and risk governance;
- the roles, responsibilities and structures of the risk, compliance and audit functions;
- compensation arrangements;
- disclosure and transparency with respect to a banking organization's governance framework; and
- the role of supervisors.

Summary versions of the 13 principles are reproduced in Annex 1.

III. COMMENTS RECEIVED

The Basel Committee received more than 15 comment letters on the 2014 Consultative Version, focused principally on four themes:

[7] The Basel Committee as a general matter does not publish a regulatory preamble that explains its decisions and, for example, its rationale for adopting or not adopting changes in response to comments made by the public. This lack of transparency has been the subject of policy debate in the United States. *See e.g.*, U.S. Senate Committee on Banking, Housing, & Urban Affairs, Hearing on the Role of the Financial Stability Board in the U.S. Regulatory Framework (Jul. 8, 2015).

1. *Board function as "oversight"*. Commenters uniformly argued that the 2014 Consultative Version conflated the responsibilities of the board and senior management, placing too much responsibility on the board for day-to-day management of the banking organization. Commenters objected to the use of the term "ensure" when referring to board responsibilities, arguing that these references should be replaced with terms such as "oversee" or "monitor" to more accurately describe a board's oversight function.

2. *Scope of director fiduciary duties*. Many commenters were concerned that the 2014 Consultative Version inadvertently increased or created new fiduciary duties for directors by framing director compliance with the duty of care and loyalty to encompass "actively engaging in the major matters of the bank and keeping up with material changes in the bank's business and the external environment as well as acting in a timely manner to protect the long-term interests of the bank." Instead, commenters were of the view that home country law – and not the Basel Committee's principles – should determine a director's fiduciary duties.

3. *Board committee flexibility*. Commenters expressed concern over the rigidity of the 2014 Consultative Version with respect to board committees. In particular, paragraph 66 of the 2014 Consultative Version required a committee chair to be an "independent, non-executive board member." Although less controversial for independent board committees, such as the audit committee, commenters argued that banking organizations should be afforded greater flexibility for other committees. Commenters also took issue with the 2014 Consultative Version's prohibition on the chair of the audit or risk committee serving as the chair of the board or any other committee. Finally, commenters found the recommended joint meetings of risk and audit committees to be unnecessary, given cross-committee membership of individual directors and the fact that committees typically report back to the board.

4. *Responsibility for risk management*. Commenters criticized the proposal that the board be responsible for implementing a banking organization's enterprise-wide risk governance framework. Instead, commenters argued that the board should oversee the framework, ensuring that it exists and is consistent with the banking organization's strategy – but should not be tasked with implementing the framework.

IV. WHAT DID OR DID NOT CHANGE IN THE 2015 PRINCIPLES

The 2015 Principles make a number of changes to the 2014 Consultative Version, incorporating certain comments received.

- *Role of the board*. The most significant changes in the 2015 Principles are to the role of the board, including acknowledgement that the role of the board is one of oversight. The term "ensure" was largely replaced with "oversee" throughout the 2015 Principles. The term "oversee" is itself a defined term in the 2015 Principles, meaning to "oversee and be satisfied with." For example, paragraph 26 was changed to require the board to "oversee," rather than "establish and monitor," "the development of and approve the bank's business objectives and strategy and monitor their implementation." Nonetheless, not all references to "ensure" were similarly edited. For example, under paragraph 44, "the board should ensure that the risk management, compliance and internal audit functions are properly positioned, staffed and resourced and carry out their responsibilities independently, objectively and effectively." This appears to indicate the increased regulatory focus on the board's role in risk management.

  The 2015 Principles retain the requirement that the board chair should be an independent or non-executive board member, but remove the requirement that the board chair not be the chair of any board committee.

- *Board committee responsibilities*. The 2015 Principles make selected changes to requirements for the audit, risk, compensation and nominating and governance committees. For the audit committee, the 2015 Principles add a responsibility for framing policy on internal audit and financial reporting and acknowledge that there should be effective communication and coordination between the audit committee and the risk committee, while not requiring these two committees to hold periodic joint meetings. The risk committee, for its part, should, in addition to the compensation committee, examine whether incentives provided by the remuneration system take into consideration "risk, capital liquidity and the likelihood and timing of earnings." Lastly, the nominating and governance committee was given the added responsibility of ensuring that the board is not dominated by one individual or group in a manner detrimental to the banking organization as a whole and ensuring that objectivity and independence are preserved on the supervisory board, where such board is separate from a management board.

- *Reflecting risk in compensation policies*. The 2015 Principles add a new concept of "material risk takers," *i.e.*, employees with significant influence on the banking organization's overall risk profile, to Principle 11. These material risk takers should have specific compensation provisions that reflect, contain

and minimize their risk taking, including deferral of a sufficiently large portion of their compensation until after risk outcomes are better known. The 2015 Principles also include a recommendation that banking organizations act quickly to claw back compensation when necessary to improve the chances of recovery.

- *Increased focus on whistleblowing.* While included in the 2014 Consultative Version, whistleblower protections and oversight by the board of those protections take on greater prominence in the 2015 Principles. The board has the responsibility for overseeing the integrity, independence and effectiveness of the banking organization's policies and procedures for whistleblowing. This includes oversight of the whistleblowing policy mechanism and ensuring that senior management addresses issues raised. The board is responsible for ensuring that retaliation against whistleblowers does not occur, and senior management is to inform the board of issues raised as a result of the banking organization's whistleblowing procedures.
- *Risk management function and role of the Chief Risk Officer.* Changes to Principle 6's discussion of the risk management function clarify that this function is responsible for developing and implementing the enterprise-wide risk governance framework with the review and approval of the board and that risk management staff should have access to regular training. To avoid conflicts of interest, risk managers should not oversee activities for which they previously held business line responsibility or participated in business decision-making or the approval process. Likewise, the 2015 Principles add a recommendation that the Chief Risk Officer not sit on credit committees to avoid conflicts of interest if the Chief Risk Officer has to flag or criticize the exposure at a later time. The revised 2015 Principles also make it clear that the Chief Risk Officer is responsible for staff training and enhancements to systems, policies and procedures to ensure that risk management capabilities are sufficient to support the banking organization's strategic objectives and risk-taking activities. The Chief Risk Officer is also responsible for supporting the board in its engagement with and oversight of the development of the banking organization's risk appetite.

V. WHAT SHOULD BANKING ORGANIZATIONS DO FROM HERE?

As noted above, we believe the federal banking agencies view the 2015 Principles as best practices, particularly in matters of corporate governance not addressed in the Enhanced Prudential Standards, the OCC Guidelines or other supervisory guidance. For example, the Enhanced Prudential Standards do not impose requirements on a board's nonexecutive chair / lead director or audit committee. Nonetheless, like the Basel Committee, Federal Reserve Governor Daniel Tarullo

has highlighted the view that a board's nonexecutive chair or lead director and the audit committee are important to effective oversight of a financial institution's risk decisions.[8]

Therefore, we believe it is a worthwhile exercise for banking organizations to benchmark their current practices against the 2015 Principles. While benchmarking may sound at first like a theoretical exercise, there are numerous prescriptive recommendations in the 2015 Principles of which banking organizations should be aware. A template for benchmarking the structure of a board and its committees against the 2015 Principles is included in Annex 2.

Moreover, given their detailed nature, the 2015 Principles may provide additional color on how the U.S. banking agencies believe the Enhanced Prudential Standards, the OCC Guidelines and other relevant supervisory authorities should be implemented. For example, the 2015 Principles provide greater detail than the OCC Guidelines on board self-assessments, which may assist banking organizations subject to the OCC Guidelines in developing their assessment processes.[9] Finally, benchmarking practices against the 2015 Principles also may be useful for smaller banking organizations currently not subject to the Enhanced Prudential Standards or the OCC Guidelines, particularly if the banking organization is approaching the $50 billion asset threshold for application of these additional prudential standards.

It also may be advisable for a banking organization to review the results of the benchmarking exercise with the senior management and its board's nominating and corporate governance committee and consider changes, if any, that could be made to current corporate governance practices based on the 2015 Principles.

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Please do not hesitate to contact us with any questions.

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[8] Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System. Corporate Governance and Prudential Regulation, Remarks at Association of American Law Schools Midyear Meeting, Washington, D.C. (June 9, 2014), http://www.federalreserve.gov/newsevents/speech/tarullo20140609a.pdf. *See* 2015 Principles ¶¶ 62, 68-70. Moreover, numerous reports indicate that Federal Reserve staff is in the process of revising Supervision & Regulation Letter 12-17, Consolidated Supervision Framework for Large Financial Institutions.

[9] *Compare* 2015 Principles ¶59 *with* OCC Guidelines, III.F.

Annex 1

The 2015 Principles' summary versions of the 13 principles are reproduced below.

Principle 1: Board's overall responsibilities. The board has overall responsibility for the bank, including approving and overseeing management's implementation of the bank's strategic objectives, governance framework and corporate culture.

Principle 2: Board qualification and composition. Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance role and be able to exercise sound, objective judgment about the affairs of the bank.

Principle 3: Board's own structure and practices. The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

Principle 4: Senior management. Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.

Principle 5: Governance of group structures. In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring the establishment and operation of a clear governance framework appropriate to the structure, business and risks of the group and its entities. The board and senior management should know and understand the bank group's organizational structure and the risks that it poses.

Principle 6: Risk management function. Banks should have an effective independent risk management function, under the direction of a chief risk officer, with sufficient stature, independence, resources and access to the board.

Principle 7: Risk identification, monitoring and controlling. Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.

Principle 8: Risk communication. An effective risk governance framework requires robust communication within the bank about risk, both across the organization and through reporting to the board and senior management.

Principle 9: Compliance. The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should establish a compliance function and approve the bank's policies and processes for identifying, assessing, monitoring and reporting and advising on compliance risk.

Principle 10: Internal audit. The internal audit function should provide independent assurance to the board and should support board and senior management in promoting an effective governance process and the long-term soundness of the bank.

Principle 11: Compensation. The bank's remuneration structure should support sound corporate governance and risk management.

Principle 12: Disclosure and transparency. The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

Principle 13: The role of supervisors. Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.

Annex 2

Benchmarking vs. Principle 3* (1 of 3)

Basel Recommendation	Compliance	Comments
Organization and assessment of the board		
57. Structure itself to effectively carry out its oversight role and responsibilities		
58. Maintain and periodically update organizational rules, by-laws and other similar documents		
59. The board should carry out regular assessments of the board, its committees and individual board members		
60. The board should maintain appropriate records of its deliberations and decisions, including dissenting opinions		
Role of the chair		
61. The chair should possess the requisite experience and competencies to ensure the proper functioning		
62. The chair should be an independent or non-executive board member		
62. If the chair is an executive, the board should take mitigating measures, *e.g.*, having a lead board member		
Board committees		
63. The board should establish certain specialized board committees to increase efficiency and allow deeper focus		
64. Each committee should have a charter that sets out its mandate, scope and working procedures		
64. The board should consider rotation of members and chairs of committees		
65. The board should disclose the committees it has established, their mandates and composition		
66. Committees should maintain appropriate records of their deliberations and decisions		
67. A committee chair should be an independent, non-executive board member		

* Banking organizations that are U.S. listed companies will comply with many of the Basel Committee corporate governance principles applicable to board structure and practices by virtue of their compliance with requirements applicable to U.S. listed companies.

Benchmarking vs. Principle 3 (2 of 3)

Basel Recommendation	Compliance	Comments
Audit committee		
68. The committee is required for systematically important banks and strongly recommended for others		
68. The committee should be distinct from other committees, have an independent chair and have independent members		
68. The committee members should have experience in audit practices, financial reporting and accounting		
69. The committee is responsible for framing policy on internal audit and financial reporting, oversight of the financial reporting process, oversight over auditors, reviewing audit scope, etc.		
70. The committee should have a balance of skills, expert knowledge and relevant experience		
Risk committee		
71. The committee is required for systemically important banks and strongly recommended for other banks		
71. The committee chair should be an independent director; not the chair of the board or another committee		
71. The committee should be a distinct committee, have independent members with risk management experience		
71. The committee should discuss risk strategies, review risk policies and oversee management processes		
72. The committee must advise the board, oversee senior mgmt. and the CRO, report on risk management		
73. The committee's work includes oversight of the strategies for capital and liquidity management		
74. The committee should receive regular reporting from the CRO and other relevant functions		
75. The committee should have effective communication and coordination with the audit committee		

Benchmarking vs. Principle 3 (3 of 3)

Basel Recommendation	Compliance	Comments
Compensation Committee		
76. The committee should support the board in overseeing remuneration system design and operation consistent with culture, legal and regulatory requirements		
Other Board Committees		
77. The board should have a nomination and corporate governance committee		
77. The board should have an ethics/compliance committee		
78. The specialized committees should have an appropriate mix of skills and experience to understand the relevant issues		
79. If executive members are on the board, the committees should have objectivity, including non-executives and independents		
Conflicts of interest		
82. The board should oversee implementation and operation of conflicts of interest policies and manage any conflicts		
83. The board should have a formal written conflicts of interest policy and an objective compliance process		
84. The board should oversee and be satisfied with the process by which appropriate public disclosure is made relating to conflicts policies and potential conflicts		
85. This disclosure should include the bank's approach to disclosing and managing conflicts consistent with the policies and within the group		
86. A potential conflict of interest occurs where a bank is both owned by the state and subject to banking supervision of the state; if such conflict exists, separate ownership and banking supervision functions		