

VENABLE[®]_{LLP}

**SARBANES-OXLEY:
IDENTIFYING THE CHALLENGES AND
RESPONSIBILITIES FOR YOUR BANK**

BY:

**RONALD R. GLANCZ
THOMAS W. FRANCE**

**ABA SECTION OF BUSINESS LAW
SPRING MEETING
LOS ANGELES, CA**

APRIL 3-6, 2003

I. THE SARBANES-OXLEY ACT OF 2002: A NEW ERA OF CORPORATE GOVERNANCE

- On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. Since becoming law, Sarbanes-Oxley has sparked a flurry of rulemaking by the Securities and Exchange Commission (“SEC”), as well as the New York Stock Exchange (“NYSE”) and the National Association of Securities Dealers, Inc. (“NASD”), and there has been much discussion and anticipation about the impact and consequences Sarbanes-Oxley and these new rules will have on corporate America.
- Sarbanes-Oxley affects the most significant changes in the regulation of corporate activity since the 1930s, including additional disclosure obligations of public companies, new corporate governance requirements, a new scheme for regulating the accounting industry, and enhanced enforcement powers and criminal penalties to fight corporate malfeasance.
- In addition, beyond the legal and regulatory changes, Sarbanes-Oxley seeks to change the very culture that underlies and shapes corporate behavior. Consequently, it is significant for all companies, not just the public companies directly impacted. Additionally, depository institutions and their holding companies and affiliates should be particularly aware of the regulatory regime imposed by Sarbanes-Oxley because it overlaps with certain regulatory requirements under the Federal banking laws and, therefore, may impact the regulatory approach taken by bank regulators.
- In light of these changes and the challenges they present, this presentation will:
 - Summarize the provisions of Sarbanes-Oxley and related SEC rulemaking, as well as the corporate governance proposals of the NYSE and Nasdaq;
 - Compare the new disclosure and corporate governance regime under Sarbanes-Oxley with certain existing regulatory requirements under the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”); and
 - Suggest some “best practices” for your Board and management team.

II. SUMMARY OF SARBANES-OXLEY: UNDERSTANDING THE NEW REQUIREMENTS AND THEIR IMPACT ON YOUR BANK

A. CORPORATE RESPONSIBILITY

Sarbanes-Oxley attempts to enhance corporate responsibility by, among other things, requiring senior executives to vouch for their company's SEC reports and financial statements, prohibiting certain loans to insiders, requiring senior executives to forfeit bonuses and stock profits under certain circumstances and strengthening audit committees.

1. *Certification of Financial Reports*

- As directed by Sarbanes-Oxley, the SEC has adopted rules requiring the principal executive officer and principal financial officer of a public company to certify in each of the company's annual and quarterly reports filed with the SEC that:
 - He or she has reviewed the report;
 - To his or her knowledge, the report does not contain any untrue statement of a material fact or omit a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
 - To his or her knowledge, the financial statements and other financial information included in the report fairly present in all material respects the financial condition, results of operations and cash flows of the company as of and for the periods presented in the report;
 - He or she (1) is responsible for establishing and maintaining "disclosure controls and procedures," (2) has designed such disclosure controls and procedures to ensure that material information relating to the company and its subsidiaries is made known to him or her, particularly during the period in which the periodic report is being prepared, (3) has evaluated the effectiveness of the disclosure controls and procedures as of a date within 90 days prior to the report, and (4) has presented in the report his or her conclusions about the effectiveness of the disclosure controls and procedures;

- He or she has disclosed to the company’s auditors and audit committee (1) all significant deficiencies in the design or operation of the internal controls that could adversely affect the company’s ability to record, process, summarize and report financial data and has identified for the auditors any material weaknesses in internal controls, and (2) any fraud, whether or not material, that involves management or other employees who have a significant role in the company’s internal controls; and
 - He or she has indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.
- “Disclosure controls and procedures” is a new concept distinct from internal controls and embodies controls and procedures addressing the quality and timeliness of disclosure. The term is defined under the SEC rules as controls and other procedures designed to ensure that information required to be disclosed in periodic and other SEC reports is recorded, processed, summarized and reported in a timely manner.
- Additionally, under Section 906 of Sarbanes-Oxley, the CEO and CFO are required to certify in each periodic report filed with the SEC that contains financial statements that:
 - The report containing the financial statements fully complies with the requirements of the Securities Exchange Act of 1934, as amended; and
 - The information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company.
 - These Section 906 certifications subject the CEO and CFO to criminal liability in the event the CEO or CFO knows they are not true.

2. Prohibitions on Loans to Officers and Directors

- Public companies are prohibited from making personal loans to any executive officer or director of the company, subject to limited

exceptions, including exceptions for loans made or maintained by an insured depository institution subject to Regulation O.

- This prohibition does not apply to loans made prior to July 30, 2002, provided that such loans may not be materially modified in any manner.

3. *Forfeiture of Bonuses and Profits of CEO and CFO*

- If a company is required to prepare an accounting restatement due to material noncompliance of the company, as a result of misconduct, with any financial reporting requirement under the securities laws, then the CEO and CFO of the company must reimburse the issuer for:
 - Any bonus or other incentive- or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC of the financial document embodying such financial reporting requirement; and
 - Any profits realized from the sale of securities of the issuer during that 12-month period.

4. *Audit Committees*

- As a requirement for listing with the NYSE, Nasdaq or any other national securities exchange or association, each company must comply with the following requirements:
 - The audit committee must be directly responsible for the appointment, compensation and oversight of any accounting firm employed by the company for preparing or issuing an audit report or related work, and each such accounting firm must report directly to the audit committee;
 - Each member of the audit committee must be an independent director, meaning that such member does not accept any consulting, advisory or other compensatory fee from the company (other than fees for service on the board of directors and any committee thereof), or is not an affiliated person of the company or any subsidiary;
 - The audit committee must establish procedures for:

- the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters; and
- the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters;
- The audit committee has the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties; and
- The company must provide appropriate funding, as determined by the audit committee, for compensation of the accounting firm employed to issue an audit report and to any advisers employed by the audit committee to assist it in carrying out its duties.

5. *Improper Influence*

- Sarbanes-Oxley directs the SEC to adopt rules making it unlawful for any officer or director of a company, or any person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate or mislead any accountant engaged in the performance of the audit of the company's financial statements for the purpose of rendering such financial statements materially misleading.

6. *Insider Trades During Pension Fund Blackout Periods*

- No executive officer or director may buy or sell any equity security of the company acquired by such officer or director in connection with his or her service to the company during any "pension fund blackout period," which generally means any period during which participants in the issuer's 401(k) or similar plans are subject to trading restrictions on company securities held for their account in such plans.
- Regardless of the intent of an officer or director who violates this prohibition on trading, any profit earned is recoverable by the company in an action initiated by the company or by a stockholder acting on behalf of the company if the company does not initiate or delays in initiating such action.

B. ENHANCED FINANCIAL DISCLOSURES

Sarbanes-Oxley requires new disclosures in SEC reports that are designed to provide investors with better information, as well as influence corporate behavior.

1. *Disclosures in Periodic Reports*

- A company's periodic and other reports filed with the SEC will need to contain the following disclosures:
 - Each financial report that contains financial statements and that is required to be prepared in accordance with generally accepted accounting principles ("GAAP") must reflect all material correcting adjustments that have been identified by the company's accountants in accordance with GAAP and SEC rules;
 - Each 10-K and 10-Q filed with the SEC must disclose all material off-balance sheet transactions, arrangements, obligations and relationships that may have a material current or future effect on financial condition, results of operations, liquidity, capital expenditures or resources, or significant components of revenue or expenses;
- Pro-forma information contained in any 10-K, 10-Q or other report filed with the SEC, or in any press release or other public disclosure, must be presented in a manner that (1) does not contain an untrue statement of a material fact or omit a material fact necessary in order to make the pro-forma information not misleading, and (2) reconciles it with the financial condition and results of operation of the issuer under GAAP.
- Earnings releases must be filed on a Form 8-K

2. *Disclosures of Insider Transactions*

- Officers, directors and stockholders subject to the Section 16 reporting requirements are now required to report most purchases and sales of the company's securities on Form 4 within two business days of the transaction.
- Effective no later than July 30, 2003, Form 4 reports will need to be filed with the SEC electronically and will need to be posted on the SEC website and the company's website no later than the end of the business day following the filing.

3. *Management Assessment of Internal Controls*

- A company's Form 10-K must contain an internal control report, which:
 - States the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
 - Contains an assessment, as of the end of the most recent fiscal year, of the effectiveness of the internal control structure and procedures for financial reporting.
- A company's outside auditors must attest to management's assessment of the internal control structure and procedures for financial reporting.

4. *Code of Ethics for Senior Executive and Financial Officers*

- Companies are required to disclose in their periodic reports whether or not they have adopted a code of ethics for the principal executive officer, principal financial officer, comptroller, principal accounting officer, or persons performing similar functions, and if not, the reasons therefor.
- "Code of Ethics" means such standards as are reasonably designed to deter wrongdoing and to promote:
 - Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
 - Full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed and in other public communications;
 - Compliance with applicable governmental laws, rules and regulations;
 - The prompt internal reporting to the appropriate person identified in the code of violations of the code; and
 - Accountability for adherence to the code.

- Companies will be required to disclose on a Form 8-K any change in or waiver of the code of ethics for any officer subject to the code.
- The code needs to be made publicly available.

5. *Audit Committee Financial Expert*

- Companies are also required to disclose in their annual report whether or not the audit committee includes at least one member who is an “audit committee financial expert,” and if not, the reasons therefor.
- The term “audit committee financial expert” is defined to mean a person who has:
 - An understanding of GAAP and financial statements;
 - The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
 - Experience in preparing, auditing, analyzing or evaluating financial statements that present a level of complexity of accounting issues generally comparable to the complexity of the issues that can reasonably be expected to be raised by the company’s financial statements, or experience actively supervising persons engaged in such activities;
 - An understanding of internal controls and procedures for financial reporting; and
 - An understanding of audit committee functions.

6. *Enhanced SEC Review and Real Time Disclosures*

- Sarbanes-Oxley directs the SEC to review reports and financial statements filed by issuers on a regular and systematic basis and in no event less frequently than once every three years.
- The SEC is directed to adopt rules requiring issuers to disclose to the public on a “rapid and current basis” such additional information concerning material changes in the financial condition or operations of the issuer as the SEC determines is necessary or useful for the protection of investors.

- For certain issuers with a public float of \$75 million or more, the deadline for filing the Form 10-K will accelerate from 90 days to 60 days after fiscal year end and the deadline for filing Form 10-Qs will accelerate from 45 days to 35 days after fiscal quarter end. These accelerated filing deadlines will be phased in over a three-year period.

C. AUDITOR INDEPENDENCE

As a result of Sarbanes-Oxley, public companies will be required to reevaluate, and in many cases alter, their relationship with their outside auditors.

1. *Non-Audit Services*

- A registered public accounting firm that performs any audit for a company is prohibited from providing to such company, contemporaneously with the audit, the following non-audit services (the “Prohibited Services”):
 - Bookkeeping or other services related to the accounting records or financial statements of the company;
 - Financial information systems design and implementation;
 - Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
 - Actuarial services;
 - Internal audit outsourcing services;
 - Management functions or human resources;
 - Broker or dealer, investment adviser, or investment banking services;
 - Legal services and expert services unrelated to the audit; and
 - Any other service that the newly created Public Company Accounting Oversight Board (the “Accounting Board”) determines, by regulation, is impermissible
- An accounting firm may provide non-audit services not listed as Prohibited Services, including tax services, to an audit client,

provided the provision of any such service is approved in advance by the client's audit committee.

- The Accounting Board may, on a case by case basis, exempt any person, issuer, public accounting firm or transaction from the prohibition on the provision of Prohibited Services to the extent such exemption is necessary or appropriate in the public interest and consistent with the protection of investors, subject to review by the SEC

2. *Audit Committee Approval*

- All audit services and, subject to *de minimus* exceptions, all non-audit services, provided by an accounting firm to a company must be approved in advance by the company's audit committee. The company must disclose in its periodic reports filed with the SEC any non-audit services approved by the audit committee. The audit committee may delegate to one or more members of the audit committee who are independent the authority to pre-approve audit and non-audit services.
- An accounting firm that performs any audit for a company must timely report to the audit committee of the company:
 - All critical accounting policies and practices to be used;
 - All alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternative treatments, and the treatment preferred by the accounting firm; and
 - Other material written communications between the accounting firm and management, including any management letter or schedule of unadjusted differences.

3. *Conflicts of Interest and Rotating Audit Partners*

- It is unlawful for an accounting firm to provide any audit service to a company if the CEO, CFO, controller, chief accounting officer or any person serving in an equivalent role for the company was employed by the accounting firm and participated in any capacity in the audit of the company during the one-year period preceding the date of the initiation of the audit.
- Further, it is unlawful for an accounting firm to provide any audit service to a company if the lead audit partner has performed audit

services for the company in each of the five previous fiscal years of the company.

D. CRIMINAL FRAUD AND WHITE COLLAR PENALTY ENHANCEMENTS

- Sarbanes-Oxley makes criminal several acts of misconduct relating to financial reporting or impeding SEC investigations and increases the criminal penalties that may be imposed for violations of the securities laws.
- For instance, Sarbanes-Oxley:
 - Subjects the CEOs and CFOs required to make the certifications under Section 906 of Sarbanes-Oxley to a fine of up to \$5 million and/or imprisonment of up to 20 years for knowingly making a certification that is incorrect;
 - Requires auditors to maintain and preserve audit workpapers and materials for a period of seven years and subjects any person that destroys or alters such audit workpapers and materials to a fine and/or imprisonment of up to 10 years;
 - Subjects any person who destroys, alters or falsifies records with the intent to impede or obstruct any governmental investigation or proceeding to a fine and/or imprisonment of up to 20 years;
 - Subjects any person who knowingly commits securities fraud to a fine and/or imprisonment of up to 25 years; and
 - Prohibits parties found guilty of securities fraud from discharging in bankruptcy any debts for which they are responsible as a result of such conduct.

E. PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

- Sarbanes-Oxley establishes the Accounting Board to regulate the accounting industry. The Accounting Board was organized in October 2002 and is a non-governmental, nonprofit corporation consisting of five members appointed by the SEC.
- Each of the members of the Board serves on a full-time basis for a five-year term and no more than two members may be certified public accountants.
- The duties of the Board include the following:

- Register public accounting firms that prepare audit reports for public companies;
- Establish and adopt rules governing auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for public companies;
- Conduct inspections of registered public accounting firms;
- Conduct investigations and disciplinary proceedings concerning registered public accounting firms and impose sanctions where appropriate; and
- Generally enforce compliance with the Sarbanes-Oxley, the rules of the Accounting Board, professional standards and securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto.
- No accounting firm that is not registered with the Accounting Board may prepare or issue, or participate in the preparation or issuance of, any audit report with respect to any company.
- The SEC will have oversight and enforcement authority over the Accounting Board, including removal of Accounting Board members for cause, approval of rules established by the Accounting Board and review of disciplinary actions taken by the Accounting Board.
- The Accounting Board will be funded with fees assessed to public companies based on market capitalization.

F. NYSE AND NASD PROPOSALS

The NYSE has proposed changes to its corporate governance and listing standards and the NASD, which governs Nasdaq, has proposed rules for Nasdaq-listed companies. The proposed rules changes are awaiting final comments and/or approval by the SEC. Following is a summary of the significant provisions of the NYSE and the NASD proposals.

1. NYSE CORPORATE GOVERNANCE AND LISTING STANDARDS

- In June 2002, the NYSE announced recommendations for additional corporate governance and listing requirements. These recommendations were approved with some modifications by the NYSE board of directors on August 1, 2002 and submitted to the

SEC for review and comment on August 16, 2002 and October 8, 2002.

- The NYSE has adopted significant changes to its listing standards which are intended to increase the role and authority of the independent directors; tighten the definition of “independent” director and add new audit committee qualification requirements; foster a focus on good corporate governance; give shareholders more opportunity to monitor and participate in governance; and establish new control and enforcement mechanisms.
- The following is a list of the NYSE proposals with respect to listed companies:
 - A majority of the board of directors must consist of independent directors (two year transition period for implementation).
 - For a director to be independent, the board of directors must affirmatively determine that the director has no material relationship with the company (either directly or as a partner, shareholders or officer of an entity that has a relationship with the company).
 - No director who is a former employee of the company or its auditor, a former employee of a company whose compensation committee includes an officer of the listed company, or an immediate family member of the above shall be deemed to be an independent director for a five-year “cooling-off” period after such employment.
 - The company must have audit, nominating/corporate governance and compensation committees, each consisting solely of independent directors, and each such committee must adopt written charters that address certain minimum responsibilities.
 - Non-management directors must meet without management in regular executive sessions and must publicly disclose the name of the director who will preside at such meetings.
 - The company must have an internal audit function, and the sole remuneration for audit committee members must be directors’ fees.

- The company must adopt and publish a code of business conduct and ethics and must promptly disclose any waivers for directors or executive officers.
- A stockholder vote is required for all equity-based compensation plans, except employment-inducement options, option plans acquired through mergers and tax-qualified plans such as ESOPs and 401(k)s.
- The CEO must certify in the company's annual report that he or she is not aware of any violation by the company of NYSE corporate governance standards.
- The NYSE may issue a public reprimand letter for violation of a corporate governance standard, in addition to the existing penalty of delisting.
- The NYSE urges every company to establish an orientation program for new directors and will develop a formal program for the continuing education of directors.

2. *NASD PROPOSALS*

- In July 2002, the NASD proposed rules for members of Nasdaq. The proposed rules cover several areas, some of which are discussed below.
 - *Increased Board Independence.* In an effort to increase the independence of the Board of Directors of Nasdaq-listed companies, the NASD proposed the following changes to the rules governing such companies:
 - Require a majority of independent directors on the board;
 - Require regularly convened executive sessions of the independent directors;
 - Require that a company's audit committee or a comparable body of the board of directors review and approve all related-party transactions;
 - Prohibit an independent director from receiving any payments (including political contributions) in excess of \$60,000 other than for board service and extend such prohibition to the receipt of payments by a family member of the director;

- Prohibit a director from being considered independent if the company makes payments to a charity where the director is an executive officer and such payments exceed the greater of \$200,000 or five percent of either the company's or the charity's gross revenues;
 - Provide that a shareholder owning or controlling 20% or more of the company's voting securities will not be considered independent;
 - Provide that any relative of an executive officer of an issuer or its affiliates will not be considered independent;
 - Prohibit former partners or employees of the outside auditors who worked on a company's audit engagement from being deemed independent; and
 - Apply a three-year "cooling off" period to directors who are not independent due to: (1) interlocking compensation committees; (2) the receipt by the director or a family member of the director of any payments in excess of \$60,000 other than for board service; or (3) having worked on the company's audit engagement.
- *Enhanced Role for Independent Directors.* In order to enhance the role of independent directors, the NASD proposed the following changes:
 - Require independent director approval of director nominations; and
 - Require independent director approval of the compensation of the CEO and other executive officers.
 - *Empower Audit Committees.* In an effort to utilize and empower audit committees, the NASD has proposed the following rules:
 - Require that audit committees have the sole authority to hire and fire the outside auditors;
 - Require that audit committees approve, in advance, the provision by the auditor of all services not related to the audit;

- Require that audit committees have the authority to consult with and retain legal, accounting and other experts in appropriate circumstances;
 - Require that all audit committee members be able to read and understand financial statements at the time of the appointment rather than “within a reasonable period of time” thereafter; and
 - Limit the time that a non-independent director may serve on the audit committee pursuant to “exceptional and limited circumstances” to two years, and prohibit that person from serving as the chair of the audit committee.
- *Stock Option Approval.* The NASD has proposed to require shareholder approval for the adoption of all new stock option plans and for any material modification of any existing or new plans, subject to limited exemptions.
 - *Miscellaneous.* The NASD has also proposed the following rules:
 - Require mandatory continuing education for all directors;
 - Require companies to establish and make publicly available a code of conduct addressing, at a minimum, conflicts of interest and compliance with applicable laws, rules and regulations;
 - Clarify that a material misrepresentation or omission by an issuer to Nasdaq may result in the company being delisted; and
 - Require that a going concern qualification in an audit opinion be disclosed through the issuance of a press release.

III. FDICIA AND ITS LESSONS FOR COMPLIANCE WITH SARBANES-OXLEY

A. REGULATORY EXPERIENCE OF DEPOSITORY INSTITUTIONS

- As outlined above, Sarbanes-Oxley imposes many new disclosure requirements and corporate governance restrictions on public companies. Although Sarbanes-Oxley will require all public companies, including depository institutions and/or their holding companies, to make significant adjustments in the manner in which they operate, depository institutions

have an advantage over non-financial companies in that they already have experience dealing with the regulatory requirements imposed under FDICIA and the other Federal banking laws and regulations, some of which are similar to those imposed by Sarbanes-Oxley.

- In some cases, the requirements and limitations under FDICIA are more stringent than those under Sarbanes-Oxley.
- Perhaps most importantly, because of their experience with Federal banking laws and regulations, depository institutions and their holding companies are experienced and familiar with the enhanced regulatory structure that Sarbanes-Oxley introduces to public companies.

B. SUMMARY OF CERTAIN REQUIREMENTS UNDER FDICIA

1. Annual Management Report

- Each insured depository institution with \$500 million or more in assets is required to submit a publicly available annual management report to the Federal Deposit Insurance Corporation (“FDIC”) and its appropriate Federal or state regulatory agency.
- The report must be signed by the chief executive officer and chief financial or accounting officer and must contain a statement of management’s responsibilities for:
 - Preparing financial statements;
 - Establishing and maintaining adequate internal controls and procedures for financial reporting; and
 - Complying with laws and regulations designated by the FDIC or the appropriate Federal agency as relating to safety and soundness
- The report must provide management’s assessments of the effectiveness of the institution’s internal controls and its compliance with designated safety and soundness laws and regulations.

2. Audit Committee Independence

- Insured depository institutions are required to establish an audit committee composed entirely of outside directors who are independent of management.

- The board of directors of the institution is required to determine annually whether the members of the audit committee are independent of management.
- In determining whether an outside director is independent, the board should consider all relevant information, including whether the director:
 - Is or has been an officer or employee of the institution or its affiliates;
 - Serves or served as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;
 - Is a relative of an officer or other employee of the institution or its affiliates;
 - Holds or controls, or has held or controlled, a direct or indirect financial interest in the institution or its affiliates; and
 - Has outstanding extensions of credit from the institution or its affiliates.
- An outside director should not be considered independent if such director:
 - is, or has been in the preceding year, an officer or employee of the institution or any affiliate; or
 - owns or controls, or has owned or controlled within the preceding year, assets representing 10% or more of any outstanding class of voting securities of the institution.
- The audit committee of any insured depository institution that has total assets of more than \$3 billion shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution.
- The audit committee is responsible for reviewing with management and the outside auditors the basis of the annual management report.

3. *Managerial Standards and Compensation*

- FDICIA subjects management of insured depository institutions and their holding companies to extensive review and evaluation by the FDIC and appropriate Federal and state bank regulators.
- Consideration of managerial standards by the regulators includes the competence, experience and integrity of officers and directors.
- Management compensation is subject to scrutiny and regulation by bank regulators. For instance:
 - Excessive compensation of executive officers, employees and directors is prohibited as an unsafe and unsound practice. Compensation shall be considered excessive when amounts paid are unreasonable or disproportionate to the services performed, considering the following:
 - The combined value of all cash and non-cash benefits provided to the individual;
 - The compensation history of the individual and other individuals with comparable expertise at the institution;
 - The financial condition of the institution;
 - Comparable compensation practices at comparable institutions;
 - For post-employment benefits, the projected total cost and benefit to the institution;
 - Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and
 - Any other factors the appropriate banking regulator determines to be important.
 - Certain undercapitalized institutions are subject to limitations on their ability to pay bonuses and increase the compensation of executive officers.

- Troubled institutions, and their holding companies or affiliates, may be prohibited from entering into “golden parachute payment” arrangements with insiders and other affiliates of the institution.
- Institutions and their holding companies and affiliates are limited in the types of indemnification arrangements they can enter into with insiders and other affiliates.

4. *Limits on Insider Transactions*

- Section 22(h) of the Federal Reserve Act and Regulation O, as amended by FDICIA, impose restrictions on extensions of credit to directors and officers of insured depository institutions and their holding companies.
- The restrictions include the following :
 - Loans to insiders must be made on substantially the same terms (including interest rates and collateral) as those for other persons.
 - In addition, loans to insiders may only be made if the institution follows underwriting procedures that are at least as stringent as those applicable to other loans and such loans do not involve more than the normal risk of repayment or present other unfavorable features.
 - Loans to insiders are subject to the loans-to-one borrower limit.
 - All loans to insiders cannot, in the aggregate, exceed the institution’s unimpaired capital and unimpaired surplus.

C. COMPARISONS WITH SARBANES-OXLEY

1. *Applying Existing Practices to New Corporate Governance Standards*

- One of the more controversial and debated provisions of Sarbanes-Oxley is the requirement that the principal executive officer and principal financial officer make certain certifications in the company’s SEC reports regarding the financial and other information disclosed in the reports and the company’s disclosure controls and internal controls.

- Although the assessments in the management reports required by FDICIA are not identical to the certifications required under Sarbanes-Oxley, the processes already in place for making the assessments can be applied by the institution (or its holding company) to making the Sarbanes-Oxley certifications.
- Further, as a result of the management report required under FDICIA, senior executives of depository institutions are familiar with the enhanced accountability now imposed on all public companies by the Sarbanes-Oxley certification requirements.
- Additionally, the requirement under Sarbanes-Oxley for management to assess the company's internal control structure and financial reporting procedures is similar to the required assessments in the management report required under FDICIA.
- The new audit committee requirements under Sarbanes-Oxley and the NYSE and NASD proposals will require many public companies to restructure the composition and responsibilities of their audit committees. These new requirements will pose less of a burden for depository institutions and their holding companies, however, due to the existing audit committee requirements under FDICIA.

2. *Restrictions on Insiders*

- Another controversial provision of Sarbanes-Oxley is the prohibition on extensions of credit to officers and directors. As discussed above, however, this prohibition does not apply to institutions subject to the limits on insider transactions under Regulation O. Although this provision will not apply to depository institutions subject to Regulation O, it may require changes in the practices of their holding companies or affiliates that are not subject to such Regulation.
- Although Sarbanes-Oxley imposes some restrictions on the behavior and compensation of management that are designed to enhance accountability of executives, the standards imposed under FDICIA are still much more stringent. Therefore, executives of depository institutions should be better conditioned to the new requirements under Sarbanes-Oxley than executives of non-bank companies.

3. *Enhanced Regulatory Scrutiny*

- Beyond the specific provisions of Sarbanes-Oxley, the intent of the law is to change the culture underlying corporate behavior through enhanced regulatory scrutiny.
- Because of their experience with FDICIA and other Federal banking laws and regulations, depository institutions and their holding companies are better positioned than other companies to respond to the cultural changes encouraged by Sarbanes-Oxley.

IV. **MEETING THE CHALLENGES OF SARBANES-OXLEY: SUGGESTED BEST PRACTICES**

A. **Restoring Confidence in Corporate Governance**

- Underlying the new regulatory, compliance and enforcement structure imposed by Sarbanes-Oxley is a desire to restore confidence in our companies and markets by ensuring transparency, accountability, courage and leadership in corporate governance. Accordingly, satisfying the mandates of Sarbanes-Oxley requires more than mere compliance with the technical requirements set forth in the Act and the rules promulgated by the SEC and the NYSE and NASD.
- In the wake of Sarbanes-Oxley, directors and senior executives of public companies should
 - step back and evaluate the shortcomings of their company's corporate governance structures;
 - take an honest view of what, fundamentally, brought us to this place; and
 - consider how to present the integrity of their company to the public.
- Following is a summary of several basic issues companies should consider in addressing the changes and challenges presented by Sarbanes-Oxley, which are examined in more detail in the article by Benjamin R. Civiletti, Chairman of Venable LLP and former Attorney General of the United States, titled "*Confidence, Courage and Leadership in Corporate Governance: Moving Beyond the New Letter of the Law,*" a copy of which is included with these materials.

B. Supporting a Strong and Active Board of Directors

1. Finding the Right Directors

- Nominating Committees should establish a mechanism for continually identifying and recruiting top-notch candidates in the same manner that companies search for top executive talent.
- Nominating Committees should begin this process by articulating clearly their selection criteria for outstanding directors – they should be well qualified, independent and represent the diversity of viewpoints necessary for rigorous and healthy debate about the company’s strategies, operations and results.

2. Ensuring That Directors are Properly Educated about the Fundamentals of the Business

- All board members should have a basic understanding of accounting and financial reporting.
- In order to allow the board members to do an effective job, companies should have an effective continuing education program to ensure that each director understands the fundamentals of the business.
 - For instance, companies should consider developing programs in which senior leaders of key departments – including finance, treasury, legal, risk management, marketing and key operating divisions – regularly brief members of the board.
 - They should likewise solicit an overview of the company and its industry from the external auditor, with special emphasis on important risk areas.
- The board should spend time with the leaders of the internal audit team to ensure that the function is strong, sufficiently staffed, appropriately skeptical and inquisitive, and understands its direct line of reporting and communication to the audit committee.

3. Ensuring Director Independence

- Companies need to thoroughly understand the new requirements and criteria for the independence of directors under Sarbanes-Oxley and the NYSE and NASD proposals.

- The Nominating Committees should articulate clearly the goals for the composition of the board and should outline explicitly the restrictions or limitations on board members, including the standards of independence.

4. *Demonstrating Confidence, a Sense of Duty and Courage in Corporate Boardrooms*

- The role of directors should not be regarded as merely advisory, either by the directors themselves or management.
- Instead, directors should be encouraged to understand the business and ask tough questions and not to merely endorse the recommendations and actions of senior management, the accountants or other advisors entirely and to become engaged only when that trust is betrayed.

C. *Creating a Culture of Transparency, Accountability and Active Disclosure*

1. *Establishing Accountability at the Top*

- Companies should seek and encourage senior executives to encourage transparency and create a culture where full disclosure – whether it be good news or bad news – is the most honorable act; a culture where performance standards are objectively derived and measured; a culture that expects both senior executives and managers to have command of the details and does not suffer anyone who is either aloof from the facts or a manipulator of them; a culture where reasonable results, legitimately gained, are applauded and where stellar results, gained illegitimately, are grounds for dismissal; a culture where no one is ever “shot” solely for having the courage to bear bad news or to ask the hard question.

2. *Facilitating Communication*

- One of the important considerations under Sarbanes-Oxley and the SEC Rules is that all material information—both financial and non-financial—gets to those responsible for reporting it to the investing public.
- The appropriate methods for ensuring the effective communication of information will depend on the size and organization of the company. Obviously, smaller companies may enjoy the advantage of being able to have senior

management interact directly with the persons responsible for collecting and processing information, whereas practical limitations may require larger companies to rely on more formal committee or business unit meetings to transmit information from the gatherers to the decision makers.

- Nonetheless, regardless of its particular circumstances, a company must be vigilant in examining its processes for communicating information with an eye towards identifying and addressing potential breakdowns.

3. *Supporting Strong and Independent Audit Committees*

- One of the best ways to assure that a company does, indeed, “do the right thing,” is to create and support a strong, capable and independent audit committee with access to all of the resources and information necessary to exercise the audit function as it was intended.
- Sarbanes-Oxley mandates a meaningful and regular role for the audit committee in the disclosure process by requiring the principal executives to certify that certain matters are disclosed to the committee in connection with each report. In addition, the outside auditors are required to report to the audit committee on a variety of specific topics, and audit committee members must be prepared to spend the time and energy to probe the issues discussed by the auditors and to work with the auditors to temper management’s advocacy of an aggressive approach to a particular accounting or reporting issue.
- The Audit Committee must build a strong relationship with the auditor. This requires more than a few regularly scheduled meetings. The duties of independent auditors and audit committee members include the consideration of employee reports with respect to accounting methods utilized by the audited companies, and the accuracy of financial reports.

4. *Identifying and Involving the Appropriate Persons*

- One of the principles to be garnered from Sarbanes-Oxley and the SEC rules is that companies must identify the officers and employees who should be involved in the disclosure process and clearly define the responsibilities of such persons.
- Although principal executive and financial officers are the persons ultimately responsible for certifying the company’s

SEC reports, the new certification requirements also serve to encourage senior management to more actively define and police the responsibilities of those persons involved in collecting, processing and presenting information for disclosure.

- One suggestion the SEC offers is that companies create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. Members of such a committee could include the controller or other principal accounting officer, general counsel, principal risk management officer, investor relations officer and officers or employees associated with the company's business units.
- Another suggestion for companies is to have written policies that clearly identify the officers and employees involved in the preparation of the company's reports and define the responsibilities of such persons. In adopting and reevaluating such policies, companies should ensure that the officers and employees identified have access to all information about the company's business and that the responsibilities of such persons are commensurate with their position and capabilities.

5. *Ensuring that Corporate Policies and Procedures are Adequate*

- The requirements under Sarbanes-Oxley, as well as the new SEC rules and the NYSE and NASD proposals, will require many, if not most, companies to review and revise existing charters, policies and procedures, and perhaps adopt new charters and policies.
- Companies are well advised to review with counsel their existing policies and procedures to ensure compliance with the new regulatory requirements. At a minimum, such review should include:
 - Audit, compensation and nominating charters;
 - Code of Ethics;
 - Internal control policies;
 - Document retention policies;

- Business conduct and management operational policies; and
- Employee benefit practices and policies and employee handbook.

6. ***Restoring Accountability and Confidence to Executive Compensation***

- The reports of personal enrichment, self-dealing and excessive perks by senior executives at Enron, Tyco and others have created a heightened environment of suspicion and potential shareholder distrust over executive compensation. Meanwhile, competition has put tremendous pressure on compensation committees to deliver bigger and better compensation packages to attract and retain top executive talent.
- Regardless of the political or media environment surrounding executive compensation, boards have a duty to develop compensation standards that are reasonable, well stated and – most importantly – to see that those standards are followed.
- Executive compensation must be considered in total, taking into account all items of value an executive receives, while at the same time rewarding the executive well for the contributions he or she makes to the company’s success and well being.
- Compensation committees should take steps to minimize the level, or use, of those aspects of executive compensation that have become politically charged and have the potential to incite a backlash from shareholders, the media or employee groups. Examples of these include:
 - expensive and/or exclusive club memberships;
 - excessive personal travel on corporate jets or luxury hotels; and
 - huge golden parachutes.
- Compensation committees should avoid substantial increases in bonuses or stock options that bear no relationship to the company’s overall financial performance.

7. *Protecting and Defending Whistleblowers*

- Consistent with a policy of transparency and an appropriate legal risk management strategy, boards of directors and senior management should protect and defend those who speak up and speak out.
- Sarbanes-Oxley clearly encourages employees of public companies to report conduct reasonably believed to be in violation of the Act itself or in violation of SEC regulations and any federal law relating to fraud against shareholders.
- Sarbanes-Oxley makes it illegal for any officer, employee contractor, subcontractor or agent of a publicly held company to discharge, demote, suspend, threaten, harass or in any other manner discriminate against an employee with respect to the terms and conditions of employment on account of the employee's participation in whistleblower activities. Under certain circumstances, employers found to have violated the whistleblower protections may also be subject to criminal sanctions, including fines and imprisonment of up to 10 years.

8. *Creating an Environment of Critical and Ongoing Review and Analysis*

- In responding to Sarbanes-Oxley, companies must evaluate not only the practices and policies they employ, but also the environment and culture underlying those practices and policies.
- They must ensure that employees involved in the process have the guidance and support necessary to carry out their responsibilities and that the environment in which such employees operate not just encourages, but demands the sharing of all material information—good or bad.
- Perhaps most importantly, companies must be vigilant that their disclosure process and their compliance practices and procedures are open to active, critical analysis on an ongoing basis.

For more information, please contact Ron Glancz at (202) 962-4947, rglancz@venable.com, or Tom France at (703) 760-1657, twfrance@venable.com.