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Bank Director's Educational Program for Members of the Board

What Are The Rules and Guidelines for Director Independence?

WHITE PAPER

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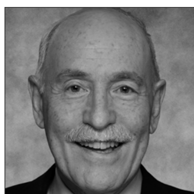

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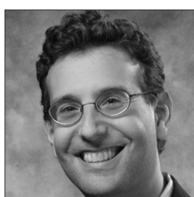

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Executive Summary*

In the last ten years, significant legislative or regulatory requirements for director indpendence have emerged. In some cases, specific metics were introduced. There's a rule, for example, that all federally insured depository institutions above $1 billion in assests must have audit committees filled exclusively with outside, independent directors. The directors of publicly traded companies must disclose certain relationships. Even the public stock exchanges have their own rules. In other situations, less formulaic approaches were adopted. In many cases, a board of directors was left to make its own judgements. This article will discuss the rules and parameters of director independence and define fiduciary duties for board members, as well as what constitutes a conflict of interest.

Background

It should come as no surprise that a crisis in the business world often gives rise to new legislation designed to prevent a future crisis or to preclude the occurrence of the events thought to have been the source of the crisis. In the recent past, the banking failures of the late 1980's and early 1990's were met with the enactment of the Federal Deposit Insurance Corporation Improvement Act, which was signed into law by President George H.W. Bush in 1991. After the corporate scandals of Enron, Tyco, WorldCom and others, Congress overwhelmingly passed the Sarbanes-Oxley Act in 2002, which was promptly signed by President George W. Bush. Finally, on the heels of the Great Recession of 2008-2009, Congress adopted the Dodd-Frank Act, which President Obama signed in 2010. Each of these statutes was designed to restore public confidence by reforming aspects of our economic system that were thought to have been damaged by the identified crisis. Interestingly, each of these legislative efforts at so-called reforming the business environment contained a pronouncement of a required level of "independence" of directors of business entities.

Your Fiduciary Duty as a Board Member

The fiduciary duty of a director includes the requirement that the director engage in decision-making free from any conflict of interest or even the appearance of such a conflict and, in all cases, that the conflict be clearly disclosed and apparent to the other members of the board of directors. Fiduciary duty often has been subdivided into three distinct duties, namely, the duties of obedi-

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ence, of care and of loyalty. The duty of obedience requires that the director act in a manner that does not extend the entity's activities beyond those authorized by the entity's organization document and by law. The duty of care requires the director to be informed with all the material information concerning any issue before the board in advance of making a business decision. The duty of loyalty raises the expectation of director independence and the lack of any conflict of interest. Adherence to these pronounced duties provides the basis for the presumption that any decisions were taken by the director in good faith are entitled to the protection of what's called the business judgment rule against a challenge from regulators, creditors or shareholders.

Duty of Loyalty

Since this duty requires the director act solely in the best interests of the business entity, it is important that the director identify and disclose whether he or she has other interests that could conflict with the interests of the company, either directly or through family or other material affiliations. Thus, the director should be able to show that any decision taken was free from any actual conflict or the appearance of a conflict.

Independent Audit Committees with Independent Members

The Committee of Sponsoring Organizations (made up of professional accounting and financial executive organizations) promoted the concept of internal controls for business organizations, including the independence of an audit committee made up of independent directors. The Federal Deposit Insurance Corporation Improvement Act of 1991 took some of the COSO concepts to the next level by mandating that each depositary institution (unless exempted by regulatory determination because of demonstrated hardship) have an "independent audit committee entirely made up of outside directors who are independent of the management of the institution. . . ." but that was later clarified in FDIC guidance. Institutions aren't required to have an audit committee if they have less than $500 million in assets. Banks and thrifts with between $500 million and $1 billion in assets must have an audit committee, and all must be outside directors, but only a majority must meet the definition of independence. Still, good governance concepts suggest that an institution have a fully independent audit committee without regard to the institution's size as one of the appropriate checks and balances to ensure the institution's safety and soundness. The FDIC standards for independence say an individual must not have served during the immediate three years as an employee, advisor, consultant, legal counsel or underwriter or otherwise participated in the institution's financial statements during that period. Also, precluding appointments are situations in which an immediate family member (broadly defined as someone living in the same household) was involved with the institution in specific instances set forth in the regulation. Generally speaking, the regulation takes great pains to exclude persons from serving only if their existing relationships might raise eyebrows.

The Rules of the Public Exchanges

The highly publicized corporate scandals of the 1990's were the impetus for the Sarbanes-Oxley Act of 2002, which applies to all public companies in the United States. Specifically, all members of the board's audit committee have to be independent but the law granted the SEC the power to delineate the meaning of "independence." Following on the adoption of Sarbanes-Oxley, the New York Stock Exchange Euronext, with the approval of the SEC, adopted changes to its Listing Manual designed to establish standards for director independence and duties for the audit, nomination and compensation committees of the boards of companies listed on the NYSE Euronext. The rule required that a majority of the members of the board of directors and all members of key board committees be independent. Rather than set categorical standards for independence, the rule mandated that the board must affirmatively determine independence based on factors such as any material relationship with the listed company (other than as a director). Banking relationships were clearly contemplated to be material in this context. The Nasdaq OMX adopted similar

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rules requiring, among other things: a majority of the members of the board of directors be independent; independent directors meet regularly in executive session; and independent directors have oversight of executive compensation. For Nasdaq OMX purposes, a director would not be considered independent if that director has a relationship which, in the opinion of the board of directors, interferes with the exercise of independent judgment in carrying out the responsibilities of a director. The Nasdaq OMX rules also disqualify a director from being independent based on that director's previous service as an employee, or otherwise receiving compensation of the company in excess of certain threshold amounts during a three-year look back period.

SEC Standards of Director Independence

The SEC sets forth those matters which would require specific disclosure. Regulation S-K addresses director independence by calling for disclosure of those relationships which could potentially give rise to a conflict of interest for a director and thereby compromise the director's independence. For example, the rule requires disclosure of a transaction between a director or a company with which the director is affiliated and the company in question, if the transaction has a value of $120,000 or more. Similarly, the rule requires disclosure if the transaction involves indebtedness to the company in question, though banking relationships in the ordinary course of business and without preferential features for the director historically have been viewed as permissible and not a conflict. The rule also includes disclosure of these sorts of transactions by directors' family members, such as spouses, children, siblings, parents and in-laws. Yet another required disclosure is of a business relationship between another company which receives material amounts of compensation or value (more than 5 percent of the company's gross revenues) from the company in question, and if the director is an executive officer or owner of more than 10 percent of the equity interest in that other company. In addition, the rule also casts a fairly wide net over any other transactions or dealings which would be material to investors. At the same time, recognizing the critical importance of the audit committee in establishing confidence in a public company's financial reporting and internal control, the SEC sought to distinguish transactions with board members which could compromise their independence from transactions with audit committee members, in particular. To that end, a director is prohibited from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from a public company in order to be able to serve on an audit committee, notwithstanding the monetary thresholds discussed above. While Regulation S-K applies only to public companies in the United States, nevertheless, it remains a useful guide for all business entities desirous of operating in a good governance environment.

Recent Pronouncements

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 added another requirement relating to the independence of public company compensation committees and their advisers. The SEC directed exchanges to develop rules ensuring each member of the compensation committee is independent, as defined by the exchanges. The NYSE and NASDAQ have done so, and the rules on director independence take effect in 2013. Also, the committee may hire compensation consultants but the board must disclose any conflicts of interest on the part of these consultants to shareholders. Thus, we have seen in the last ten years some statutory and regulatory attempts at setting strict standards for independence of directors, at least in the area of audit, nominating and compensation committees. There also has been some recognition that strict and detailed standards may be too burdensome for some companies to follow, or may be inappropriate for broad application, and therefore that a more flexible approach may be in order.

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Questions to Determine Independence of a Director

Proper board governance procedures suggest that each director and each proposed director provide answers to a series of questions designed to elicit information that could be seen as a conflict of interest and a compromise of director independence:

Business or professional connections with the company including company perquisites:

- Are you or any member of your family (which would include spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in the director's home) employed by the company or any affiliate of the company?
- Do you or any family member (as defined above) have any professional or business dealings with the company, including any dealings through another company with which you or a family member is affiliated?
- Have you or any family member received any compensation from the company of any kind, including company perquisites?
- Have you or any family member engaged in any transaction of any kind with the company?

Affiliations with the company through stock ownership or other control:

- Do you own any stock, debt or other interests in or of the company or any options to acquire same?
- Do you exercise any control over the company or any part of the company or have the means to influence any decision-making by the company by reason of participation in major policy-making functions (other than as a director)?

Existence of interests possibly adverse to those of the company:

- Are you an executive officer or director of, or a person who controls, another business entity which is a customer of the company or competes with the company or is otherwise engaged in activities which might be viewed as being adverse to the interests of the company?

Required level of skill, expertise and physical health for the exercise of independence:

- Have you ever served as a director of a company?
- Do you understand the responsibilities of being a director and your role as a member of the company's board of directors?
- Do you have an understanding of the nature of the company's business and the sources of its revenues?
- Do you understand financial statements relating to the company's business activities, including balance sheet, income statement and cash flow statement?
- Are you able to devote significant time and resources on working on matters which are the responsibility of the board?
- On how many boards of directors do you currently serve?
- Prior occurrences that might give rise to issues of credibility and trustworthiness affecting independence:
- Have you ever been convicted of a felony?
- Have you ever filed for, or had filed against you, a petition for bankruptcy or other insolvency-type proceeding?

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