

Department of the Treasury

Regulatory Bulletin

RB 37-5

Handbook: **Examination Handbook**

Subject: **Management**



Section: 310

Oversight by the Board of Directors

Summary: This bulletin provides new Examination Handbook Section 310, Oversight by the Board of Directors. This section replaces Thrift Activities Handbook (TAH) Section 310.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Thrift Policy Division of the OTS, Washington, DC. You may access this bulletin and the handbook section at our web site: www.ots.treas.gov.

Regulatory Bulletin 37-5

SUMMARY OF CHANGES

OTS is issuing Examination Handbook Section 310, Oversight by the Board of Directors. Change bars in the margins of the handbook section indicate revisions. We provide a summary of substantive changes below.

310 Oversight by the Board of Directors

We revised this section to accommodate a comprehensive safety and soundness and compliance examination process.

We also made the following changes:

- Provided a discussion on corporate governance best practices.
- Provided a discussion of the auditor independence and internal control report requirements imposed on public savings associations pursuant to the Sarbanes-Oxley Act.
- Added a section on the Composition of the Board of Directors.
- Added a discussion of the Sister Bank Exemption and how it relates to independence and separate corporate governance existence requirements.
- Revised the program and questionnaire to include procedures that reflect the above revisions.

—Scott M. Albinson

Managing Director




Examinations, Supervision, and Consumer Protection

Oversight by the Board of Directors

The board of directors oversees management activities and is ultimately responsible for the affairs of a savings association. Laws and regulations governing board activities require directors to exercise care and loyalty toward the savings association and not to advance their own personal or business interests at the expense of the savings association.

RESPONSIBILITIES OF THE BOARD OF DIRECTORS

As the financial services industry continues to evolve, the duties of directors are becoming more complex and demanding. In addition, the corporate scandals of 2002 and the Sarbanes-Oxley Act have raised public awareness in the area of corporate governance. Today's board of directors must take an active role in shaping and controlling a savings association's business operations and risks. The following are some basic responsibilities the board has in actively overseeing the association's affairs:

LINKS	
	Program
	Questionnaire
	Appendix A

- Establish business goals, standards, policies and procedures, and operating strategies and understand the risks involved in following certain strategies.
- Approve standards for ensuring that the savings association's transactions with affiliates are sound, and are considered solely from the association's interests.
- Establish a compliance program emphasizing the importance of regulatory compliance as an inherent part of business operations ensuring compliance with external standards, such as laws and regulations, and the association's own policies and procedures.
- Hire and retain executive officers with the skills, integrity, knowledge, and experience appropriate for the nature and scope of their responsibilities and periodically evaluate management's performance.
- Establish and maintain appropriate committees that have written charters delineating the committee's functions, responsibilities, and membership qualifications.
- Ensure that the association maintains a corporate existence that is separate from its affiliates, subsidiaries, holding company, and sister banks.

- Ensure that the association serves the credit needs of its community or communities and meets responsibilities under the Community Reinvestment Act (CRA).
- Review operating results, compliance performance and performance of new and existing activities.

In fulfilling these responsibilities, the board of directors should observe the following standards:

- Operate independently from management.
- Stay well informed and be attentive to risk.
- Attend board meetings regularly.
- Conduct business affairs ethically; avoid conflicts of interest and self-serving practices.

OTS federal charters for mutual and stock associations authorize the number of directors to be not fewer than five nor more than 15, except when the Director of OTS approves a lesser or greater number. A quorum for board meetings is the majority number of directors that an association's bylaws prescribe, even if the association has not yet elected the prescribed number.

For a list of board of directors' statutory and regulatory responsibilities, see the References at the end of this Handbook Section and the Questionnaire.

Analyzing Board Performance

Evaluating the effectiveness of a board of directors is an important examination function. The results often provide a useful indicator of an association's future condition and help OTS design a regulatory profile. In carrying out the evaluation, you should perform the following steps:

Evaluating the effectiveness of a board of directors is an important examination function.

- Tailor the scope of the examination to the risk profile of the association. A comprehensive assessment of each director and officer usually is not necessary.
- Concentrate on issues rather than on personalities. Analyzing the board's performance is a sensitive process that requires focusing on problem solving, not fault finding.
- Determine the level of director awareness and accountability. Board members should know and fulfill their responsibilities.

To evaluate board effectiveness you must review board minutes and other documents, interview management, and check on the board's response to supervisory directives. In rare instances, you may need to expand the scope of the examination and interview individual directors. You should only need

to do this if the information is unavailable from other sources. Meetings with the entire board provide an additional means of evaluating a board's effectiveness. See [Examination Handbook Section 070](#).

Directors generally welcome regulatory review and specific recommendations for improvements. In unusual cases, however, directors may be uncooperative or attempt to hide instances of incompetence, lack of care, or even fraud or criminal malfeasance. Possible causes for the condition of a troubled association include any of the following reasons:

- Self-dealings or other conflicts of interest.
- Unsafe and unsound practices.
- Management incompetence.
- Lack of director participation.
- Domination of the board by one director or officer.
- Disregard for the regulatory process.
- Lack of independence.

The board is ultimately responsible for prevention or correction of these problems. If the board is unable or unwilling to correct serious problems, you must act immediately to protect the association and ensure its safety and soundness. For more information in this regard, refer to [Thrift Activities Handbook Section 370, Enforcement Actions](#).

Board Minutes

The primary sources of information you need to evaluate a board of directors and its actions are the minutes of its regular and committee meetings. You should review these minutes to determine the status of the following areas:

- Adequacy of management's reports to the Board – Management reports submitted to the board should be thorough and accurate and cover all aspects of the association's operations. Management should provide such reports to the directors before regular board or committee meetings to allow adequate time for review before the meetings.
 - Reports should document any significant changes to capital, financial performance results, compliance performance, and major business activities, including information technology risks.
 - Reports for technology risks should address information security, technology audit work, business continuity planning, and vendor oversight activities. Additionally, the minutes

should document that the board received a status report on and approved the association's compliance with the Interagency Guidelines Establishing Standards for Safeguarding Customer Information, which implement Section 501(b) of the Gramm-Leach-Bliley Act of 1999.

- Oversight of management – Minutes should reflect the board's discussion and approval of any major strategic or operating decisions and the adoption of major operating policies and procedures. Management should obtain board approval before implementing new policies or engaging in new activities.
- Attendance and participation – The minutes should evidence "regular" attendance by board members. Attendance at 75 percent of all regularly scheduled board meetings is the benchmark for "regular" attendance. Minutes should also identify board members who ask questions or make motions, indicating that they are active in the meetings. Another indicator of active involvement is participation on committees.
- Performance evaluations – Minutes should reflect the board's election of officers, its review of management performance, and its deliberations regarding salaries and compensation for officers and fees for attorneys, appraisers, directors and others.
- Compliance with board directives – Savings associations should have internal systems to monitor operations and ensure that management's actions are appropriate and conform to board-approved policies and directives.

Board minutes should be a complete and accurate representation of meeting discussions, including dissenting opinions or votes. Minutes should indicate that the directors studied pertinent documentation and based their decisions upon such documentation. Each director should have the opportunity to review and, if appropriate, modify the minutes before the board ratifies them. However, board minutes should never be altered to distort facts.

Reports to the Board

A board's excessive reliance on benchmark financial statistics rather than on comprehensive financial analysis suggests that the directors may not be overseeing the association's affairs appropriately. Undue reliance on only a few indicators may result in erroneous evaluations of the association's condition.

The quality of report information that management provides to board and committee members is critical in a board's decision-making process.

Therefore, you should determine that the reports to the directors include information that is complete, supported, understandable, and accurate.

The quality of report information that management provides to board and committee members is critical in a board's decision-making process. Not only must directors carefully review information that management provides,

they must also ensure themselves that the information is complete and contains all pertinent data required to oversee the association.

Each regular board meeting should include a review of financial reports. Directors should not accept questionable report figures at face value, but should question the information and verify it when necessary. The association should promptly follow federal or state examination report recommendations. The audit committee composed solely of outside directors, if necessary, should provide for annual audits by an independent accounting firm, and should ensure the establishment of and adherence to a system of internal controls.

Audit Committee

The board should appoint an audit committee composed of directors who are independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member. Members should also be independent of operating personnel who audit procedures, systems, or records. Operating personnel may, however, attend meetings to provide necessary information.

The major responsibilities of the audit committee include:

- Handling relations with the independent auditor (such as to select the auditor and to discuss the scope and results of the audit).
- Improving internal auditing functions and controls.
- Establishing policies and procedures that ensure full and accurate disclosure of the association's financial condition.
- Monitoring management and staff compliance with board policies, laws, and regulations.
- Measuring the effectiveness of the association's compliance management program.

All insured institutions with total assets of \$500 million or more must have an independent audit yearly. If any savings association is a subsidiary of a holding company, it can satisfy this requirement by an independent audit of the holding company. See [Thrift Activities Handbook Section 350, Independent Audit](#). In addition, if a savings association is publicly traded, regardless of size, it is subject to the auditor independence and certain other internal control report requirements of Sarbanes-Oxley. See attached Appendix A, Applicability of Selected Sarbanes-Oxley Act Requirements to Financial Institutions. Ideally, independent auditors provide an objective look at the performance of the association. You should carefully review independent audits for the following red flags:

- A qualified or adverse opinion.
- Significant adjustments to net income or capital.
- Internal control deficiencies, especially if recurring or not reported by the internal audit.

- Significant variances in time spent by auditors on the premises or in the audit expense incurred by the institution.
- Significant disagreements between management and the independent auditors.
- Significant variances from findings in the reports of examination.
- Failure of management to submit a plan for the correction of deficiencies.
- Late audit reports (more than 90 days from fiscal year-end).

Compliance Officer and Audit

A compliance officer who has direct access to the board and all areas of operations plays a key role in the internal audit function. It is the responsibility of this officer to monitor the association's business transactions to ensure compliance with regulatory provisions and safety and soundness standards.

The compliance officer, the audit committee, or the outside auditor, should annually prepare a compliance audit report. An audit of this nature will give the association an opportunity to resolve any internal problems that might otherwise be the subject of an adverse examination report.

Qualified Management

A board's most important responsibility is to select a capable managing officer (or chief executive officer) for the association. The board is also responsible for appointing or approving other senior management. Although economic conditions are a major influence on a savings association's well being, capable management and personnel are the dominant factors that contribute to an association's success.

Directors should give the chief executive the latitude he or she needs to run day-to-day operations; therefore, the board must be certain that the person is competent and trustworthy. As a further control, the board should define a managing officer's duties and responsibilities in writing and establish an adequate management succession plan. (See [Examination Handbook Section 330, Management Assessment](#).) The board should also establish reasonable compensation packages, including appropriate incentives, for executive officers. In addition, the directorate is responsible for evaluating the performance of top management.

Board Oversight of Management

The board of directors must ensure that a savings association's management has procedures in place to implement board-adopted policies. The board should ensure that management performs the following functions:

- Hires and retains employees and agents with the skills, integrity, knowledge, and experience appropriate to the nature and scope of their responsibilities. Proactively engages and supervises vendors.
- Provides ongoing comprehensive training programs, including the association's information security program.
- Follows the board's direction and provides periodic reports to the board concerning policy compliance, such as interest rate risk exposure reports, earnings and capital projections and analysis, and information security.
- Develops, implements, and monitors a comprehensive compliance management program predicated on systems, real-time monitoring, periodic self-assessment, organizational accountability, responsiveness to needed improvements, and effective training (OTS's SMAART compliance program components).
- Maintains an awareness of regulatory issues and developments.
- Reviews the board's policies periodically and suggests changes when appropriate.
- Develops, tests, and implements a comprehensive, association-wide business continuity plan that reflects the technology environment.
- Implements and manages operations to achieve the board's financial objectives and establishes operational policies for financial functions.
- Supervises investment portfolio management activities. Invests excess liquid funds in securities that complement the association's overall risk/return profile.
- Maintains an awareness of the economic and interest-rate environment, particularly local economic conditions, prepayment trends, volatility, and related regulatory developments.
- Reviews asset quality, including trends in delinquencies, nonaccrual loans, real estate owned, and charge-offs and recoveries. Also reviews the adequacy of reserves and quantifies the effect of nonperforming assets on the risk/return profile.
- Develops, reviews, and monitors capital plans, business plans, information technology plans, and strategic plans. Integrates this role with the budgeting function. Also generates variance and rate and volume analysis reports.
- Provides adequate support, planning, and oversight when the association enters nontraditional banking activities, new business lines, or acquires and implements significant new technology. Considers these activities, which may be organizationally distinct from the association's

operations, in connection with the association's overall risk/return profile. Sets specific standards concerning risks and assumptions.

- Manages capital market activities, including capital raising, debt issuance, dividend policies, and merger and acquisition analysis. Considers these activities with the management of the association's overall risk/return profile.
- Ensures that product development activity and pricing comport with the association's overall risk/return objectives. Compares the savings association's product pricing to a sample of key competitors.

Use of Consultants

Savings associations sometimes hire third parties, such as consulting firms, investment bankers, lawyers, accountants, or other professionals, to provide services not usually required in the normal course of business. Consultants normally provide such services before and during proposed mergers, systems conversions, implementation of new technology, capital raising efforts, major asset sales, boards of director's internal investigations, and defenses against regulatory determinations. The board of directors must justify and approve contracts that the association enters into with third parties. Using a third party to perform services does not diminish the board's responsibility to ensure that services are provided in a safe and sound manner, and in compliance with applicable laws and regulations. Generally, the risk management policies that apply to a savings association conducting an activity directly, also apply to third parties conducting activities on the association's behalf. See TB 82a, Third Party Arrangements.

The board of directors should remind management to take care in contracting with outside parties that propose to provide business plans or financial models at no direct cost to the association. Such vendors usually expect the association to transact business with them on an exclusive basis, and management may feel an obligation to do so. These vendors will have exclusive access to detailed information about the association that could lead to proposals or transactions that are not in the association's best interest.

The board should ensure that management does not rely on outside consultants to excess, or use overly simplistic assumptions.

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Policies and Procedures

The board establishes policies as guidelines for an association's activities. Procedures represent the methodology for implementing an activity. Operating policies and procedures are necessary to establish management's strategy to communicate the association's goals and to provide a basis for gauging performance.

The directors must provide a clear framework so that the managing officer can operate and administer the association's affairs. These areas include the business strategy as set forth in the business plan, investment and loan policies, capital planning, funds management, risk management, including technology risks and controls, information security policies and procedures, and compliance policies and procedures. The Handbook covers these areas in other sections. The board of directors must approve all major policies.

Board policies and procedures should meet the following parameters:

- Establish and provide guidance and direction for an association's operations.
- Exist for all major phases of the association's operations.
- Be tailored to the association's operations and risk profile.
- Provide guidance and promote controlled and efficient operating practices.

Management's implementation of board policies and procedures and the association's adherence to operating standards indicate the effectiveness of the board. Positive indications of successful implementation of policies and procedures include:

- Current policies and procedures.
- Established systems to support stated objectives.
- Required evaluations and benchmarks for measuring and monitoring performance.

Business Plan

Directors are responsible for establishing a business plan that documents major financial policies, including funds management, lending, investments, dividends, growth, and interest rate risk management. For more information on the latter, refer to the Interest Rate Risk Management Handbook Section and Thrift Bulletin 13a. While management may develop such policies at the direction of the board, the directors must thoroughly review and give final approval to each contemplated policy. Directors must also approve the association's budget and ensure that it is realistic, allows for secure transactions, and reflects adequate capital.

Ideally, the board should have access to information on economic issues because the performance of the economy affects the savings association's performance. Early recognition of changes in the economy provides notice of new opportunities or potential deterioration of asset quality.

Setting Financial Goals: The Risk vs. Return Tradeoff

Savings associations generally express overall financial return objectives in terms of net earnings maximization or net equity value maximization. These financial goals are subject to internal and

external risk factors. The greater the risk embedded in individual assets, portfolios, or the overall institution, the greater the variability of returns over time.

The board of directors and management must realize that the savings association can generate higher returns (earnings or equity value) only if the association takes on greater risk; this is the risk/return tradeoff. The choice between these two alternatives relates to the management of all the association's financial functions.

To manage risk effectively, a savings association must have an informed board of directors that is capable of guiding the association's risk strategy. It is important for the board to develop a rational decision-making process for determining a savings association's optimal risk/return profile. An analysis of the effect of numerous risk/return tradeoffs is crucial to successful financial management. See [Thrift Activities Handbook Section 510](#).

Types and Sources of Risk Exposure

There are several significant types and sources of risk exposure applicable to savings associations. For each type and source, the board of directors must provide direction to management as to the extent of risk the association may undertake.

Credit Risk – The risk that the borrower or issuer will not repay principal or interest on loans or investments. This area of risk includes counterparty credit risk, which is the risk that the counterparties will not honor their commitments for items such as over-the-counter option transactions or derivative instruments.

Interest Rate Risk – The vulnerability of an association's financial condition to movements in interest rates. Interest rate risk arises from four sources: repricing (mismatched) risk, yield curve risk, basis risk, and options risk. Repricing risk, the primary source of interest rate risk, comes from timing differences in the maturity and repricing of assets, liabilities, and off-balance sheet positions. Yield curve risk arises when unexpected shifts of the yield curve affect a savings association's income or economic value. Basis risk arises from the imperfect correlation in the adjustment of the rates earned and paid on different financial instruments with otherwise similar pricing characteristics. Options risk arises from options, embedded in many financial instruments, that provide the holder with the right, but not the obligation, to buy, sell, or in some manner alter the cash flows of the instrument. See Thrift Bulletin 13a for a more detailed discussion of interest rate risk. TB 13a requires the board of directors to establish and maintain an association's interest rate limits.

Liquidity Risk – The risk that funds may not be available to meet cash outflows when they arise. Liquidity risk occurs when an association is unable to liquidate assets or obtain adequate funding to continue operating. This situation may occur if the association cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions.

Compliance Risk – The risk to earnings, capital and market viability as well as on investor, customer, and regulatory relationships arising from violations of or noncompliance with laws, rules, regulations,

industry practices, internal policies and procedures, ethical standards, or customer service goals. It exposes an association to fines, civil money penalties, litigation costs, diminished reputation, reduced franchise value, and reduced business opportunities.

Other Risks – Includes operational risk, legal risk, reputation risk, fraud and insider abuse risk, and disasters or catastrophe risks.

Documentation

An integral part of a savings association's books and records includes documentation of all business transactions. The records should reflect regulatory compliance and adherence to safe and sound procedures. The directors should have full access to such records and use them in approving loans and other investment transactions.

To facilitate examinations each savings association, affiliate, and subordinate organization should establish and maintain accounting and other records that provide an accurate and complete record of all business it transacts. Associations, affiliates, and subordinate organizations must also ensure that the documents, files, and other material or property comprising the records shall always be available for examinations. For supervisory purposes, associations should retain these original business transaction records until the savings association has two regular examinations and the association and OTS resolve any supervisory matters raised in the examinations. Savings associations must also comply with the records retention requirements of safety and soundness, enforcement, compliance, nondiscrimination and consumer affairs laws and regulations.

Due to differing local customs and state laws, associations should obtain recordkeeping (including microfilming, microfiche, and digital imaging) guidance and advice from local sources, such as attorneys, independent auditors, and income tax consultants. OTS encourages associations to develop and follow a formal written recordkeeping policy and records retention schedule.

Employment Contracts and Executive Compensation

This section provides guidance for review of compensation provisions and clarifies OTS policy on unsafe and unsound practices relating to executive compensation and employment contracts.

Definitions

Compensation includes any payment of money or other items of value in consideration of employment. Compensation includes the following items:

- Base salary
- Commissions
- Bonuses

- Pension and profit sharing plans
- Severance payments
- Retirement
- Director or committee fees
- Fringe benefits
- Payment of expense items for a nonbusiness purpose, or that do not meet the IRS requirements for deductibility by the association.

OTS does not ordinarily consider the grant or exercise of stock options as compensation unless they are sufficiently material in amount or conditioned upon factors that result in incentives that cause supervisory concerns.

A senior executive officer includes any individual who holds the title or performs the function of one or more of the following positions (without regard to title, salary, or compensation):

- President
- Chief executive officer
- Chief operating officer
- Chief financial officer
- Chief lending officer
- Chief investment officer
- Chief compliance officer

Senior executive officer also includes any other person identified by OTS in writing as an individual who exercises significant influence over, or participates in, major policymaking decisions, whether or not hired as an employee.

An employment contract is any agreement, intended to be legally enforceable, that materially affects the terms and conditions of a person's employment.

A savings association is in troubled condition if it meets any of the conditions below:

- OTS notifies the association in writing that OTS has assigned the association a composite numerical rating of 4 or 5 under the Uniform Financial Institutions Rating System or an equivalent rating under a comparable OTS rating system.
- The association is subject to a capital directive, a cease and desist order, a consent order, a formal written agreement, or a prompt corrective action directive relating to the safety and soundness or financial viability of the association.
- OTS informs the institution, in writing, of its troubled condition based on information available to OTS. Such information might include current financial statements, reports of examination, or limited scope review of the institution.

General Policy

OTS regulation 12 CFR § 563.39, Employment Contracts, allows a savings association to enter into employment contracts with its officers and other employees with the specific approval of the board of directors. Savings associations may not enter into contracts that constitute an unsafe or unsound practice. The regulation defines as unsafe or unsound any practice that could lead to a material financial loss or damage. OTS regulation 12 CFR § 563.161 provides that compensation to officers, directors, and employees must be reasonable and commensurate with their duties and responsibilities.

Savings associations may not enter into contracts that constitute an unsafe or unsound practice.

Determining Compensation and Directors' Fees

OTS considers all six CAMELS components rated under the Uniform Financial Institutions Rating System in its review of employment contracts and other compensation arrangements.

OTS generally defers to the savings association's board of directors concerning executive compensation arrangements, provided that the following conditions exist:

- The institution is not in troubled condition.
- The compensation arrangements do not present significant safety or soundness concerns that could lead to material financial loss or damage to the association.
- Members of the board complied with their fiduciary duties in approving the compensation arrangement.

OTS requires the board of directors of each savings association to annually review all employment contracts and compensation arrangements for senior executive officers and directors. The board must also document its justification and approval in board minutes. Directors who have a personal interest in the compensation arrangements should not participate in the deliberations or vote on the arrangements. Renewal or extension of employment contracts requires approval by the board of directors.

In determining the compensation of principal officers, the board of directors should consider at least the following factors:

- The qualifications and experience of the officer.
- The compensation paid to other persons that the association or service corporation employs.
- The compensation paid to persons having similar duties and responsibilities in other insured associations or service corporation affiliates.
- The size of the association or service corporation, and the complexity of its operations.
- The financial condition, especially capital position and income level, of the association or service corporation and the individual's contributions to the association or service corporation.
- Any other amounts the officer receives, either directly or indirectly, for other services performed for the association or service corporation such as fees for serving as appraiser, attorney, escrow agent, insurance agent.
- The value of personnel fringe benefits provided to the employee, and perquisites such as an automobile, club membership, and expense account.

Directors should be keenly aware of their fiduciary responsibilities when they establish fees and benefits for themselves. Each director should keep in mind that a primary responsibility is to establish policies that protect the assets of the association. Thus, in setting its own fees, directors should use factors similar to those used in setting officers' compensation.

The board of directors must also determine and document whether the fees of outside appraisers and attorneys are reasonable and commensurate with the services performed. This is particularly important if the outside appraiser or attorney is an affiliated person. The board should determine whether the fees are comparable to those that other appraisers or attorneys performing similar services charge. The board should also consider the comparative advantages of employing a staff appraiser or attorney to perform appraisal or legal services for the association or service corporation.

Unsafe or Unsound Compensation Practices

OTS generally does not require changes to preexisting contracts in healthy associations. Contract provisions, however, that raise significant safety and soundness concerns will be subject to examination comment or formal enforcement action until the association terminates or modifies the contract. OTS may, on safety and soundness grounds, insist that the board replace unacceptable managers and use its best efforts to renegotiate employment contracts that are excessively burdensome on the association.

OTS reviews compensation provisions in savings associations in troubled condition under the following circumstances:

- During examinations.
- In conjunction with applications that contain compensation arrangements.
- When the association submits employment contracts and compensation payments for review.

You should review, comment, or take other appropriate action to correct unsafe or unsound employment contracts.

OTS considers the guidelines below illustrative examples of unsafe or unsound compensation provisions. Other compensation provisions may also be objectionable depending on individual circumstances. OTS bases these guidelines on safety and soundness concerns that are especially important for savings associations in troubled condition. You must use judgment in the application of the guidelines, taking into account the condition of the association, the reason for the provision, and the materiality of the provision.

The illustrative examples of unsafe or unsound compensation provisions include the following:

- Compensation arrangements that provide incentives contrary to the safe and sound operation of the association. For example, compensation based primarily on short-term operating results may encourage unreasonable risk-taking to achieve short-term profits. The board of directors should closely monitor compensation tied to current operating results.
- Compensation arrangements that significantly exceed compensation paid to persons with similar responsibilities and duties in other insured associations of similar size, in similar locations, and under similar circumstances, including financial health and profitability.
- Contracts that contain automatic renewals or extensions without providing for the board of directors explicit review and approval.
- Contracts that provide for an excessive term. Generally, a term exceeding three years is objectionable.
- Total compensation paid out upon the departure of an employee, regardless of the reason, that exceeds three times the employee's average annual compensation. (The association should not make any payment when termination is for cause.) Total compensation must include payments for the remaining contract term, if applicable, as well as any severance payments. Associations should base average annual compensation on the five most recent taxable years.
- Contracts that do not adequately reflect or define the duties and responsibilities of the employee.
- Compensation programs (including deferred compensation, retirement, and insurance) for independent directors that are not commensurate with their duties, or that jeopardize their

independence. For example, vesting requirements that require an independent director to forfeit previously accrued amounts if they do not serve for a minimum number of years.

- Contracts that the savings association collateralizes or otherwise guarantees, unless one of the following conditions are present:
 - The terms provide that the contract is unenforceable if the association becomes an association in a troubled condition.
 - The regional director approves the contract.

Note: Contracts that the holding company guarantees are permissible.

- Contracts that provide for employer reimbursement of costs that employees incurred seeking to enforce employment contract terms in the absence of legal judgment or settlement.
- Change in control provisions that provide for immediate vesting, particularly for savings associations in a troubled condition.
- Contracts that require payment upon the voluntary resignation of the employee.

The foregoing does not apply to employment contracts or other compensation arrangements between a holding company and a holding company executive. OTS does not comment on employment contracts between a holding company and a savings association executive unless such contract or arrangement is likely to adversely affect the financial or managerial condition of the association. If applicable, OTS requires separate employment contracts between a savings association executive and the association, and the savings association executive and the holding company.

Savings associations should include the following golden parachute provision in new and renewed employment contracts. “Any payments made to the employee pursuant to this agreement, or otherwise, are subject to and conditioned upon their compliance with 12 USC § 1828(k) and FDIC regulation 12 CFR Part 359, Golden Parachute and Indemnification Payments.”

Operating Results

The board of directors is responsible for maintaining an adequate level of capital for the association. See Thrift Activities Handbook Section 120, Capital Adequacy. You should be alert to salary increases and dividend payouts in an association experiencing unstable or declining levels of capital or earnings. If an association fails to meet any capital standard, you should question the board of directors and management of the association. They should justify any increases in compensation for principal officers and directors or dividend payouts.

The board of directors is responsible for maintaining an adequate level of capital for the association.

OTS bases its regulatory and supervisory scheme on performance-based standards that tie directly to capital compliance. Well-capitalized, well-managed institutions that do not pose significant supervisory concerns receive significantly less intrusive oversight, including a longer examination cycle.

Presented below are some of the more common restrictions placed on undercapitalized associations or those institutions in troubled condition.

Capital Plan

OTS requires a capital restoration plan when an association falls below its adequately capitalized level. The association must adhere to an OTS approved capital restoration plan and comply with all prompt corrective action restrictions.

Capital Distribution Restrictions

OTS regulation 12 CFR § 563.134, Capital Distributions, establishes limits on capital distributions.

Prior Approval of Officers and Directors

Section 563.560 requires savings associations in troubled condition to provide 30 days prior notice to OTS if the association wishes to add a director or employ a senior executive officer. OTS has the authority to disapprove the addition or employment of the individual within a 30-day period. OTS may extend the 30-day period for an additional period not to exceed 60 days and must notify the individual in writing of the extension.

Prior Approval of Employment Contracts

A savings association in troubled condition must submit all senior executive officer and director employment contracts to the regional director for prior review. The regional director may extend this requirement to other employees of the association as well. Compensation at associations in troubled condition requires regulatory scrutiny on a case-by-case basis. OTS must balance the association's need to lower operating expenses against the need to provide a higher than normal level of compensation to attract and retain qualified management.

Golden Parachute Provisions

FDIC regulation 12 CFR Part 359, Golden Parachute and Indemnification Payments, implements 12 USC § 1821(k). Part 359 prohibits, with certain exceptions, troubled insured institutions from making golden parachute payments.

The FDIC's Part 359 defines a golden parachute payment generally as any payment that meets the following criteria:

- The institution makes the payment to an institution-affiliated party.

- The payment is contingent on this person's resignation.
- The institution makes the payment while it is in troubled condition.

An institution-affiliated party includes any director, officer, employee, or controlling stockholder (other than a depository institution holding company) of, or agent for, an insured depository institution or depository institution holding company. The rule excepts legitimate business expenses such as the following from the golden parachute payment prohibition:

- Qualified retirement plans.
- Nonqualified "bona fide" deferred compensation plans.
- Nondiscriminatory severance pay plans.
- Other types of common benefit plans.
- Certain payments required by state law.
- Death benefits.

The regulation provides for other limited exceptions in cases involving the hiring of a new manager to improve the institution's condition or when the owners sell a troubled institution without FDIC assistance.

Regulatory Review of Third-Party Contracts

A savings association with a composite CAMELS rating of 4 or 5 must first notify and receive Regional Director approval before it enters into third-party contracts for services outside the normal course of business. OTS has particular concerns regarding third-party contracts at troubled associations because they frequently waste scarce resources. The regional director may establish a de minimis threshold amount to apply on a case-by-case basis. The requirement for regional director preapproval does not apply to contracts in the normal course of business, such as annual audits, debt collection, or routine legal services.

Third-party contracts must not contain provisions that are detrimental to the savings association or contrary to public interest. You should scrutinize them closely since the costs may ultimately increase the cost of an association's failure to the

A savings association with a composite CAMELS rating of 4 or 5 must first notify and receive Regional Director approval before it enters into third-party contracts for services outside the normal course of business.

deposit insurance fund. You should use the following guidelines when reviewing such contracts for associations with a composite CAMELS rating of 4 or 5:

- Associations must clearly identify the services the consultant will provide and discuss how they relate to the association's approved business or capital plan.
- The association must provide evidence that fees to be paid and terms of payment are within prevailing market norms and are consistent with the interests of the insurance fund.
- Reimbursable expenses, if provided, should include only necessary costs directly related to the service provided. (OTS does not consider costs such as entertainment and unnecessary travel as reasonable.)
- Each contract must contain a provision stating that the association may cancel for unsatisfactory or nonperformance.
- In most circumstances, associations should enter into only one contract for each service a consultant will perform. OTS generally considers multiple contracts to different providers for the same service to be a dissipation of assets.
- The association must receive written approval from the regional director to enter into a proposed third-party contract.

Other Requirements

Directors should be ever-mindful of the savings association's obligation to serve the community. Directors represent the association and their behavior can enhance or detract from the association's image and ultimately its fiscal well-being. A director's business and personal affiliations should be compatible with those of the association.

You should be alert to self-serving practices that include:

- Gratuities to directors to obtain their approval of financing arrangements.
- The use of particular services.
- The use of association funds by insiders to obtain loans or transact other business.
- Transactions involving a conflict of interest.

Composition of the Board of Directors

The composition of the board must meet the following requirements of 12 CFR § 564.33:

- A majority of the directors must not be salaried officers or employees of the savings association or any subsidiary or (except in the case of a savings association having 80% or more of any class of voting shares owned by a holding company) any holding company affiliate thereof.

- Not more than two of the directors may be members of the same immediate family.
- Not more than one director may be an attorney with a particular law firm.

Accordingly, boards should be made up of both inside and outside directors, each providing a distinct role:

- *Inside directors* are responsible for approving high-level budgets prepared by upper management, implementing and monitoring business strategy, and core corporate initiatives and projects. Inside directors are either shareholders or high-level management from within the company. Inside directors help provide internal perspectives for other board members.
- *Outside directors* have the same responsibilities as the inside directors in determining strategic direction and corporate policy; however, outside directors are different in that they are not directly part of the management team. The purpose of having outside directors is to provide unbiased and impartial perspectives on issues brought to the board.

Conflicts of Interest

Directors must particularly avoid conflicts of interest of any sort, or even the appearance of a conflict of interest. Also, because a director's personal characteristics may reflect on the association's trustworthiness, a director should be a responsible and trusted member of a community. OTS's regulation on conflicts of interest, 12 CFR § 563.200, prohibits persons who owe a fiduciary duty to a savings association from advancing their own personal or business interests at the expense of the association. This regulation also prohibits persons who owe a fiduciary duty to the savings association from advancing the personal or business interests of others with whom they have a personal or business relationship at the expense of the association.

The following examples are types of transactions that the rule prohibits:

- A person who owes a fiduciary duty to an institution receives money or other benefits (such as a loan, forgiveness of debt, goods or services) from a third party. In return, the third party receives a benefit from the association (such as granting a loan to or buying property from the third party).
- A third party makes payments to a spouse, child, parent, sibling, or business partner of a person identified in the rule. Those payments generally provide a benefit to the person identified in the rule because of the personal or business relationship.
- A person who owes a fiduciary duty to an institution facilitates a transaction between the savings association and companies in which that person owns shares, is on the board of directors, or is an officer, at the expense of the institution.

Generally, OTS will not deem a person to be advancing his, her, or its interests at the expense of the institution if the transaction complies with sections 23A and 23B of the Federal Reserve Act and

Federal Reserve Board Regulation O. In addition, the regulation provides that if persons who owe a fiduciary duty to a savings association have an interest in a matter or transaction before the board they must take the following steps:

- Make full disclosure to the board.
- Refrain from participating in the board's discussion of the matter.
- Recuse themselves from voting on the matter if they are board members.

TWA's Sister Bank Exemption

One exemption to 23A, the Sister Bank Exemption, exists for transactions between a bank or thrift and another bank or thrift if a company controls 80 percent or more of the voting securities of both banks or thrifts or if one bank controls 80 percent or more of the voting securities of the other. According to the Federal Reserve, such exemptions reflect the fact that, under the cross-guarantee provisions of the Federal Deposit Insurance Act, an insured depository institution is generally liable for any loss incurred by the FDIC in connection with the default of a commonly controlled depository institution. Notwithstanding the cross-guarantee provisions, the board must ensure that all transactions between the thrift and its affiliates are safe and sound, and in the thrift's best interest.

Corporate Opportunity

OTS's corporate opportunity regulation prohibits directors, officers, and persons that have the power to direct the management or policies of a savings association, or otherwise owe a fiduciary duty to an association, from taking advantage of corporate opportunities that belong to the association. OTS follows common law standards governing usurpation of corporate opportunity. The following are examples of issues the board should consider under this standard:

- The institution's financial condition and management resources.
- The level of risk presented by the business.
- Potential profit from the business weighed against any profits that might arise from transfer of the business.

The rule does not apply when an institution receives fair market value consideration for the transfer of a line of business. In addition, the rule does not generally apply if a disinterested and independent majority of the savings association's directorate, after receiving a full and fair presentation of the matter, rejects the opportunity as a matter of sound business judgment. A disinterested director has no interest in the matter or transaction before the board of directors. An independent director must not be a salaried officer or employee of the savings association, any subsidiary or holding company affiliate. In addition, an independent director must not be dominated or controlled by an interested officer or director.

Political Contributions and Loans to Political Candidates and Committees

The board of directors is responsible for authorizing any political activity by a savings association and must ensure that borrowers properly report political loans.

The Federal Election Commission (FEC) administers, interprets, and enforces the Federal Election Campaign Act of 1971 (the Act) as amended (2 USC § 431). The FEC's implementing regulations that govern political contributions and bank and savings association loans are at 11 CFR Part 100.

The Act and the FEC's regulations apply to the political activities of the following entities:

- Federally chartered corporations in connection with any election, whether federal, state, or local.
- Nonfederally chartered corporations in connection with a federal election.

Thus, a state-chartered subsidiary of a federal savings association is usually not subject to the prohibitions governing its federally chartered parent, absent any circumvention of the Act or implementing regulations.

The FEC's rules and regulations prohibit savings associations from making political contributions and paying political expenditures. For federal associations these prohibitions apply to any election, but for state associations the prohibitions apply to federal elections. Directors should consult legal counsel regarding any questionable activities related to political contributions and loans or payment of expenditures to any political candidates or committees.

Besides the Act's requirements and FEC regulations, savings associations may also be subject to state and local political activity laws.

You should report apparent violations and, when appropriate, forward them to your supervisor. OTS may forward the referral to the FEC for enforcement action. You should consider filing a Suspicious Activity Report when a violation is of a serious, knowing, and willful nature.

Associations may direct their requests for FEC advisory opinions to the following address:

Federal Election Commission
Office of the General Counsel
999 E Street, N.W.
Washington, D.C. 20463

Foreign Corrupt Practices Act of 1977

Congress designed the Foreign Corrupt Practices Act (FCPA) (15 USC § 78dd – 1&2) to prevent the use of corporate assets for corrupt purposes. The FCPA makes it a crime for a U.S. company (or individuals acting on behalf of a company) to bribe foreign officials or foreign political candidates or parties to acquire or retain business. There is an exception for generally accepted “grease” payments to

facilitate processing. The FCPA applies to issuers of registered securities and domestic concerns, their officers, directors, agents, and stockholders. Under the FCPA, the company may be criminally liable if it indirectly engages in prohibited acts through any other person or entity, including a foreign subsidiary.

The FCPA also requires the establishment of internal controls to ensure that organizations execute transactions according to management's authorization and properly record the transactions so as not to disguise corrupt payments. Anyone acting on behalf of a savings association, in any transaction with a foreign official, should have benefit of legal counsel to ensure compliance with the far-reaching provisions of the FCPA.

Regulation O

Savings association directors bear a major responsibility in dealing with loans to members of the directorate and other insiders. They must make decisions that preclude the possibility of partiality or favored treatment. Losses that develop from unwarranted loans to an association's insiders or to their related interests weaken the association's general credit standards. See [Thrift Activities Handbook Section 380, Transactions with Affiliates and Insiders](#).

Reporting of Loans from Correspondent Banks

Under 12 CFR Part 215 Subpart B requirements, executive officers and principal shareholders and their related interests must submit an annual report to their board of directors regarding their indebtedness to correspondent banks. OTS incorporates this provision in 12 CFR § 563.43.

Securities Laws

Directors of stock associations must take care not to violate federal securities laws in their own securities trading activity. These laws prohibit anyone, insider or not, from purchasing or selling securities with the use of material corporate information that is not available to the general public. Examples of such material inside information include:

- Significant corporate actions.
- Reduced or increased earnings.
- Changes in loan loss reserves.
- Mergers, acquisitions, or proposed tender offers.
- Actual or potential enforcement or supervisory actions.
- A change in supervisory status (such as a prompt corrective action category or a CAMELS rating).

Federal securities laws also prohibit insiders from passing inside information to other persons, even if the insider does not actually trade securities based on such information.

Related to insider trading prohibitions are short swing profit recovery provisions of § 16 of the Securities Exchange Act of 1934 (15 USC § 78c). A “short swing” transaction generally includes purchases and sales, or sales and purchases, of equity securities within a period of six months. Section 16(b) provides that an issuer, or shareholder acting on behalf of an issuer, may recover from an insider any profits realized on certain short swing transactions.

Corporate insiders have a fiduciary responsibility of trust and confidence to refrain from trading based on material nonpublic information concerning their corporation. The misuse of material nonpublic corporate information is a fundamental breach of fiduciary duty and an unsafe and unsound practice.

Other Areas of Review

Management Official Interlocks

OTS regulations also address management official interlocks and depository interlocks. See OTS regulation 12 CFR Part 563f. A management official of a depository institution or depository holding company may not generally serve as a management official of another depository institution or depository holding company if the two organizations are not affiliated and are very large or located in the same local area.

Indemnification Payments

A federal savings association may indemnify its directors, officers, and employees according to OTS regulation 12 CFR § 545.121. Such indemnification however, is subject to and qualified by 12 USC § 1821(k). This regulation limits the ability of insured institutions to pay the liabilities or legal expenses of a director or employee who is subject to an enforcement proceeding.

Part 359 in the Code of Federal Regulations limits indemnification payments. The rule generally prohibits indemnification payments made to or for an institution-affiliated party in connection with a civil money penalty or judgment resulting from a federal administrative or civil enforcement action instituted by any federal banking agency. The rule also prohibits payment of liability or legal expenses with regard to administrative proceedings or civil actions instituted by any federal banking agency that results in a final order or settlement pursuant to which an institution-affiliated party is:

- Assessed a civil money penalty.
- Removed from office.
- Prohibited from service.
- Subject to various other penalties.

The rule permits institutions to buy commercial insurance to cover expenses other than judgments and penalties. The rule also permits the institution to pay up front for an employee's legal or other professional expenses if the institution's board makes certain findings, and the employee agrees to reimburse the institution if the alleged violation is upheld.

Insurance

Fidelity Bond Coverage

Savings associations must maintain adequate fidelity bond and directors' and officers' insurance coverage. Directors should periodically review the adequacy of this coverage and carefully review the riders thereto that might impair its utility. The terms of these policies are negotiable. See [Section 330, Management Assessment](#).

Savings associations must maintain adequate fidelity bond and directors' and officers' insurance coverage.

Life Insurance

It is common practice for savings associations to buy life insurance policies for the benefit of employees. Institutions may also obtain key-person protection for the association. If the beneficiary of the policy is the savings association, refer to [Thrift Activities Handbook Section 250, Other Assets/Liabilities](#), for applicable policy and review procedures. If the beneficiary of the policy is the employee, OTS considers the cost of the coverage to be compensation. The board should annually review and approve the policy for reasonableness.

REFERENCES

United States Code (2 USC)

The Federal Election Campaign Act of 1971

United States Code (12 USC)

§ 375b Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Member Banks (22(h))

§ 1817(a)(3) Reports of Condition

United States Code (15 USC)

§ 78m Periodical and Other Reports

§ 78dd-1&2 Prohibited Foreign Trade Practices/Foreign Corrupt Practices Act of 1977

§ 1828(k) Authority to Regulate or Prohibit Certain Forms or Benefit to Institution-Affiliate

Code of Federal Regulations (12 CFR)

Chapter II: Federal Reserve Board Rules and Regulations

Part 215 Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks
(Regulation O)

Chapter III: Federal Deposit Insurance Corporation Rules and Regulations

Part 359 Golden Parachute and Indemnification Payments

Chapter V: Office of Thrift Supervision Rules and Regulations

§ 544.5 Federal Mutual Savings Association Bylaws

§ 545.121 Indemnification of Directors, Officers and Employees

§ 552.6-1 Board of Directors

§ 560.130 Prohibition on Loan Procurement Fees

§ 561.18 Director

§ 563.33 Directors, Officers and Employees

§ 563.39 Employment Contracts

§ 563.41 Loans and Other Transactions with Affiliates and Subsidiaries

§ 563.42 Additional Standards Applicable to Transactions with Affiliates and Subsidiaries

§ 563.43 Loans by Savings Associations to their Executive Officers, Directors and Principal
Shareholders

§ 563.161 Management and Financial Policies

§ 563.200 Conflicts of Interest

§ 563.201 Corporate Opportunity in Savings Associations

§ 563.555 Notice of Change in Control of Director or Senior Executive Officer

Part 563f Management Official Interlocks

Part 570 Safety and Soundness Guidelines And Compliance Procedures
Appendix A, Interagency Guidelines Establishing Standards for Safety and Soundness
Appendix B, Interagency Guidelines Establishing Standards for Safeguarding Customer
Information

Office of Thrift Supervision Guidance

Regulatory and Thrift Bulletins

- RB 3b Policy Statement on Growth for Savings Associations
- TB 13a Management of Interest Rate Risk, Investment Securities, and Derivatives Activities
- TB 23a Sales of Securities
- TB 82a Third Party Arrangements

CEO Memos

- CEO No. 133 Risk Management of Technology Outsourcing
- CEO No. 171 OTS' Revised Compliance Self-Assessment Guide (SMAART Compliance Management Strategy)
- CEO No. 174 Joint Interagency Statement On Application of Recent Corporate Governance Initiative to Non-Public Banking Organizations
- CEO No. 176 Business Continuity Planning Booklet
- CEO No. 180 SEC's Final Rule Discussing Reports on Internal Control That May Satisfy Both SEC Requirements and FDIC Part 363 Requirements

Other References

- Office of Thrift Supervision, *Directors' Responsibilities Guide* (October 1999)
- Office of Thrift Supervision, *Director's Guide to Management Reports* (October 1999)

Oversight by the Board of Directors Program

EXAMINATION OBJECTIVES

To assess whether the composition of the board of directors provides for sufficient breadth and depth of expertise to ensure adequate oversight of the association's affairs.

To determine whether the board of directors fully understands its duties and responsibilities and is discharging its responsibilities appropriately.

To determine whether the board of directors has adopted adequate policies, procedures, and operating strategies (including internal controls, a compliance management program, and audit and loan review procedures) to conduct the association's operations prudently.

To determine the existence of any conflicts of interest or improprieties involving directors.

To determine the extent of compliance with statutory and regulatory requirements applicable to directors of savings associations.

EXAMINATION PROCEDURES

LEVEL I

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1. Review the association's business plan, budgets, and policy statements. Determine if the board of directors establishes objectives and policies for the association in general and for specific relevant areas of operation. Determine whether objectives and policies are compatible with applicable laws, regulations, the charter or articles of incorporation, bylaws, and conditions for insurance of accounts. Evaluate the adequacy of stated policies in providing direction to management.

2. Review board of director's minutes of regular, special, and committee meetings; consider director attendance at the meetings. Determine whether minutes are complete, the extent of significant changes in direction, activities, or policy for the association, and whether specific changes require modification of the scope of the examination. Update the continuing examination file (CEF), if applicable, with new

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or revised policies (or reference the policies if not retained). You should inform other examiners of noteworthy information found during the review.

3. Review reports that management prepares for the board. Determine if the information is adequate, accurate, and sufficient to support the board of director's decision making. (Examiners reviewing related areas can perform this procedure.) Confirm that management's reports adequately address financial and operational risks, including technology risks, and compliance performance. Provide copies of useful board reports and other information to the other examiners.

4. Review and evaluate the composition of the board of directors. Ensure that the association meets the requirements in 12 CFR § 563.33. Obtain answers to the following questions and disseminate information regarding directors' interests to the examination team:
 - Is there always a quorum, that is, a majority of the directors that the association's bylaws prescribe, at board meetings?
 - Do the directors, as a group, have sufficient expertise and experience?
 - Are three or more of the association's directors members of the same family? Do related directors tend to control board actions?
 - Do two or more directors also work as attorneys with the same law firm?
 - Could the directors' affiliations have any adverse effects on the association's operations and, if so, would a larger board offset the possible adverse effects?
 - Is there a concentration of board members and, therefore, a concentration of interests in certain businesses (such as real estate or construction)?

5. Determine whether there were any occurrences of self-dealing or conflicts of interest involving the board of directors.

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6. Complete the [General Questionnaire, Oversight by the Board of Directors](#).

7. Determine whether the board of directors:

- Delegates sufficient authority to management personnel to promote effective and efficient performance and foster an environment for regulatory compliance, while retaining sufficient control to discharge its responsibilities to stockholders, members, customers, OTS, and other regulatory authorities.
- Is aware of significant regulatory changes enacted during the examination period.
- Actively oversees the association's operations and adequately monitors its performance.
- Provides direction to management as to the development of an optimal risk/return profile.
- Receives a status report on and approves the association's compliance with the Interagency Guidelines Establishing Standards for Safeguarding Customer Information, which implement Section 501(b) of the Gramm-Leach-Bliley Act of 1999.
- Provides sufficient resources for implementing its compliance management program given the association's business strategies, operational complexity, and regulatory obligations.
- Is aware of all the association's funds management procedures, including management's financial modeling processes.
- Provides sound funds management direction to management.
- Reviews and takes appropriate corrective actions to address adverse findings or criticisms disclosed in internal and external audit reports, reports of examinations, and internally generated reports, such as internal asset review reports and compliance self-assessment reports.
- Reviews the level and reasonableness of officers' salaries and confirms that they are commensurate with their experience and duties.

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- Provides adequate oversight of the personnel department and its policies.
 - Reports annually to the shareholders in the required format, if applicable.
-

8. Review employment contracts. Be especially alert for contracts with long terms or overly generous provisions. Determine whether the association employs or retains persons closely related to officers and directors. Determine whether such relationships or inappropriate contracts have affected, or could adversely affect, the system of internal control, employee morale, or association performance. Ensure employee contracts meet the requirements of 12 CFR § 563.39.

9. Interview the managing officer and other key officers, including the chief financial officer and the chief lending officer. Determine whether they keep directors informed of the association's financial position and the potential effect of current economic conditions on the association. Also determine the extent of the directors participation and involvement in resolving current operating problems and establishing long-range objectives and policies.

10. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

LEVEL II

1. Obtain answers to the following questions relating to the board of directors:
- Does the board of directors review reports from the executive committee, audit committee, loan committee, other committees of the board, compliance personnel, and outside experts at board meetings?
 - Do directors and committee members have the opportunity to review and modify minutes of their meetings before approval?

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- Are directors aware of significant regulatory changes enacted during the examination period?
- Has the board appointed a compliance officer?
- Has the board adopted and maintained a comprehensive compliance management program predicated on systems, real-time monitoring, periodic self-assessment, organizational accountability, responsiveness to needed improvements, and effective training (OTS' SMAART Compliance Program Components)?
- Did management consider the results of prior years' compliance reviews and examination reports when they designed procedures for the current compliance review
- Did the audit committee or the board review the results of the most recent compliance audit, compliance reviews, and self-assessment reviews?
- Are adequate systems of internal control present to detect noncompliance with regulations?
- Are written responses and plans for corrective action required from management concerning deficiencies noted during the compliance audit, reviews, or self-assessments?

2. Did each regular director's meeting during the examination period include a review of financial reports of the association and its affiliates? Also, consider the following:

- Do the minutes reflect directors' questions concerning financial reports along with the appropriate follow-up and resolutions?
- Did the board review recommendations concerning fiscal operations in examination reports and the board of director's letter from independent accountants?
- Did the board approve and prepare written responses to recommendations contained in examination reports and the board of director's letter from the independent accountants?
- Does the board regularly assess or monitor management's compliance with board approved major financial polices?

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- Do the minutes reflect that the directors thoroughly reviewed and approved the association's budget?
 - Does management include comparisons of budgets with actual results in financial reports reviewed at each board meeting?
-

3. Did the board establish and do they annually review minimum underwriting standards and guidelines, including a large loan policy? Check the following items:

- Does management establish, and does the board review and approve formal lending limits?
 - In conjunction with the budgeting process and formulation of the business plan, has the board reviewed and approved the types and volume of lending planned by management?
 - Do the association's lending policies require that higher-risk credit extensions and unusual loans (as specifically defined in the policies) be presented to the board for final approval?
 - Do the minutes reflect if the board considered any unusual loans or those exceeding ordinary risk? Do the minutes reflect the board's approval or disapproval?
 - Do the minutes reflect that the board, in reviewing higher-risk loans, explored efforts to minimize risk and limit the amount invested?
 - Has the board implemented an effective internal asset review function?
-

4. Review the following items:

- Does the board define, in writing, the managing officer's duties and responsibilities?
- Do the directors generally establish and approve compensation levels and pension plans?
- Do directors approve promotions and bonuses and document such approvals in the minutes?

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- For bonus plans tied to the association's net income, has the board established controls to prevent management from reporting short-term gains at the expense of long-term profitability?
-
5. Review directors' compensation for reasonableness. Consider peer group information and the time directors devote to the association's affairs.
-
6. Determine if operating committees are active between board meetings, and if the committees subsequently report their actions to the board for ratification.
-
7. Review the association's bylaws, charter or articles of incorporation, and conditions for insurance of accounts. (Include copies in the CEF or permanent institution file.) Determine if written policies and procedures specify the duties and responsibilities of management personnel and the board of directors.
-
8. Review and consider the CAMELS component ratings and the compliance rating in determining your overall conclusions regarding the oversight by the board of directors.
-
9. Determine if there is a need to review any association transactions for evidence of self-dealing or conflicts of interest.
-
10. Ensure that your review meets the Examination Objectives of this Handbook Section. State your findings, conclusions, and recommendations for any necessary corrective measures on the appropriate work papers and report pages.
-

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EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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Oversight by the Board of Directors

Questionnaire

Yes No

General Questionnaire

Board of Directors - General Requirements

- | | | |
|--|--------------------------|--------------------------|
| 1. Does the board implement policies and procedures to ensure an effective system of corporate governance? | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Does the board ensure that executive officers appropriately manage and supervise day-to-day activities? | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Is the composition of the board within the guidelines of § 563.33a)? | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Have all directors regularly attended directors' meetings during the year? | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Does the board of directors regularly review reports from the executive committee, audit committee, loan committee, other committees of the board, compliance personnel, and outside experts at board meetings? | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Has each director had the opportunity to review and modify all minutes of board and committee meetings during the period prior to approval? | <input type="checkbox"/> | <input type="checkbox"/> |
| 7. Are the minutes complete? | <input type="checkbox"/> | <input type="checkbox"/> |

Conflicts of Interest - 12 CFR § 563.200

- | | | |
|---|--------------------------|--------------------------|
| 8. Does the board of directors review each director's business and personal interests to ensure that the director does not advance his interests (or interests of others that the director has a personal or business relationship with) at the expense of the savings association? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Do board members furnish written conflict-of-interest representations annually? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Has any director engaged in any transaction with the association or its affiliates where the director received preferential treatment? (Apply particular emphasis to loan terms and instruments.) | <input type="checkbox"/> | <input type="checkbox"/> |
| • Has any director engaged in any transaction with the association or its affiliates that give the appearance of a conflict of interest? | <input type="checkbox"/> | <input type="checkbox"/> |

Reporting of Loans from Correspondent Banks - 12 CFR Part 215, § 563.43, FIL-82-2000 (FFIEC-004)

- | | | |
|--|--------------------------|--------------------------|
| 9. Does the board of directors review the reports of indebtedness to correspondent banks that executive officers and principal shareholders and their related interests must annually submit to the board? | <input type="checkbox"/> | <input type="checkbox"/> |
|--|--------------------------|--------------------------|

Oversight by the Board of Directors

Questionnaire

Yes No

Safety and Soundness Standards - 12 CFR Part 570, Appendix A

10. Does the board of directors and senior managers ensure that the system of internal control operates effectively? Yes No
11. Does the association have an internal audit function that is appropriate to its size and the nature, scope, and risk of its activities? Yes No

Standards for Safeguarding Customer Information – 12 CFR Part 570, Appendix B

12. Did the board of directors approve and oversee the implementation of a written information security program, as required by the Gramm-Leach-Bliley Act (GLBA), Section 501(b)? Yes No
- Does the board receive annual reports regarding the status of the information security program, and the institution's compliance with § 501(b) of GLBA? Yes No

Annual Independent Audits and Reporting Requirements - 12 CFR Part 363

13. This section only applies to associations where total assets at the beginning of the fiscal year are \$500 million or more:
- Has the board of directors established an independent audit committee? Yes No
 - Does the committee review with management and the independent public accountant the basis for the reports that 12 CFR Part 363 requires? Yes No

Sarbanes-Oxley Public Reporting Requirements

This section only applies to public institutions that are subject to SEC reporting requirements.

14. Has the institution included in its SEC filing a management report on the company's internal control over financial reporting? *Note: Savings association and savings association holding companies may choose to prepare a single management report that satisfies both the SEC requirement and Part 363 rather than prepare two separate management reports.)* Yes No
15. Has the institution included an attestation report by the registered public accounting firm regarding management's assessment? Yes No

Oversight by the Board of Directors

Questionnaire

Yes No

Interest Rate Risk Management Procedures - 12 CFR § 563.176

16. Does the board of directors (or a designated committee of the board) review the savings association's interest rate risk exposure? Yes No
17. Has the board of directors formally adopted a policy for the management of interest rate risk? Yes No
18. Does the board of directors periodically receive reports from management regarding implementation of the interest rate risk policy? Yes No
19. Does the board of directors review the results of operations at least quarterly and make adjustments as necessary, including adjustments to the authorized acceptable level of interest rate risk? Yes No

Financial Derivatives - 12 CFR § 563.172

20. Has the board of directors established written policies and procedures governing authorized financial derivatives? Yes No

Supervisory Policy Statement on Investment Securities and End-User Derivatives Activity

21. Has the board of directors approved major policies for conducting investment activities, including the establishment of risk limits? Yes No
22. Does the board of directors review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits? Yes No

Interbank Liabilities - 12 CFR § 206.3

23. Does the board of directors annually review and approve the association's interbank liability policies and procedures? Yes No

Payment Systems Risk - 12 CFR § 210.25

24. Does the board of directors control the risks of participation in the systems by establishing caps and reviewing policy compliance? Yes No

Real Estate Lending Standards - 12 CFR § 560.101

25. Does the board of directors, at least annually, review and approve lending policies for extensions of credit secured by real estate? Yes No
26. Do the lending policies reflect risk levels that are acceptable to the board and provide clear and measurable underwriting standards? Yes No

Oversight by the Board of Directors

Questionnaire

- | | Yes | No |
|--|--------------------------|--------------------------|
| • Do the institution's lending policies require that higher-risk credit extensions and unusual loans (as specifically defined in the policies) be presented to the board for final approval? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Were unusual loans and those exceeding ordinary risk presented to the board during the period, and did the board record their approval or disapproval in the minutes? | <input type="checkbox"/> | <input type="checkbox"/> |
| • In reviewing higher-risk loans, did the board explore efforts to minimize risk and limit the amount invested, and did the directors document their review in the minutes? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Does the board review the status of all high-risk loans on a regular basis? | <input type="checkbox"/> | <input type="checkbox"/> |

Appraisal Policies and Practices of Savings Associations and Subordinate Organizations - 12 CFR § 564.8, TB 55a

- | | | |
|---|--------------------------|--------------------------|
| 27. Has the board of directors developed, implemented, and maintained appraisal policies to ensure that appraisals reflect professional competence and reliable market value of the collateral? | <input type="checkbox"/> | <input type="checkbox"/> |
| 28. Has the board of directors developed and formally approved written appraisal policies? | <input type="checkbox"/> | <input type="checkbox"/> |
| 29. Does the board of director's annually review and approve appraisers for compliance with association policies, procedures and reasonableness of estimates? | <input type="checkbox"/> | <input type="checkbox"/> |
| 30. Has the board of directors designated one or more persons as the association's environmental risk analyst and assisted in the development of the association's environmental risk policy? | <input type="checkbox"/> | <input type="checkbox"/> |

Classification of Assets - 12 CFR § 560.160

- | | | |
|---|--------------------------|--------------------------|
| 31. Does the board of directors ensure that management evaluates and classifies the association's assets on a regular basis in a manner consistent with or reconcilable to OTS's asset classification system? | <input type="checkbox"/> | <input type="checkbox"/> |
|---|--------------------------|--------------------------|

Written Security Programs - 12 CFR Part 568

- | | | |
|--|--------------------------|--------------------------|
| 32. Has the board of directors developed and implemented written security programs for the association's physical locations? | <input type="checkbox"/> | <input type="checkbox"/> |
|--|--------------------------|--------------------------|

Report of Condition - 12 USC § 1817(a)(3), TFR Instructions

- | | | |
|--|--------------------------|--------------------------|
| 33. Do two or more members of the board of directors attest to the report? | <input type="checkbox"/> | <input type="checkbox"/> |
|--|--------------------------|--------------------------|

Oversight by the Board of Directors

Questionnaire

Yes No

Report of Examination - ROE Instructions

34. Do the directors review the report of examination and sign the Director's signature page for review during the next examination?

Information Technology

35. Has the board of directors developed, adopted and implemented appropriate policies, practices, procedures, and controls to identify, manage, and mitigate information technology risks within the association's environment?

Business Continuity Planning - CEO Memo No. 176

36. Has the board of directors developed a comprehensive, institution-wide business continuity plan, appropriate to the size and complexity of the institution that clearly defines how the association can maintain, resume, and recover its operations after disruptions?

- Is the association's business continuity plan tested annually?
- Are the results of the annual testing presented to the board for review and documented in the corporate minutes?

37. Has the board of directors developed and implemented a program to oversee and manage its technology outsourcing relationships?

- Does the vendor management oversight program ensure that contracts with outsourced technology vendors contain language that the service providers implement security programs designed to meet the objective of § 501(b) of GLBA?

Third Party Arrangements – TB 82a

38. For significant contracts, does the board of directors regularly receive:

- Risk management reports, including contingency plans?
- Performance reports?
- Oversight activity reports?

39. Does the board have a policy that it must approve the third party vendor selection process, and have access to critical information with regard to the third party's activities?

40. Does the board have policies that require management to develop business plans for significant new lines of business or products that identify the planning process, decision making, and due diligence activities in selecting a third party vendor?

41. Does the board adequately document their decisions regarding third party vendors?

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Oversight by the Board of Directors

Questionnaire

Yes No

Executive Compensation and Employment Contract Oversight - 12 CFR § 563.39

42. Does the board of directors annually review and approve all employment contracts and compensation arrangements for senior officers and directors?
43. Has the board of directors defined the duties and responsibilities of the institution's managing officer in writing?
44. For those bonus plans tied to the performance of the institution has the board established controls to prevent management from reporting short-term gains at the expense of long-term profitability?
45. If the institution uses employment contracts, do they meet the requirements of § 563.39?

Bond Coverage for Directors, Officers, Employees, and Agents - 12 CFR § 563.190

46. Does the board of directors formally approve and annually review and assess the association's standard and supplemental bond coverage?

Retail Sales of Nondeposit Investment Products - TB 23-2

47. Only applicable to associations that permit the sale of nondeposit investment products on their premises:
- Does the board of directors ensure that customers receive disclosures about the nature and risk associated with nondeposit investment products?
 - Did the board of directors adopt and does the board of directors periodically update a written statement that addresses the risks associated with the association's sales program?
 - If the association uses a third party that sells or recommends its nondeposit investment products, has the board of directors approved the agreement with the third party?

Compliance Management Program – SMAART – CEO Memo No. 171

48. Has the board adopted and maintained a comprehensive compliance management program predicated on systems, real-time monitoring, periodic self-assessment, organizational accountability, responsiveness to needed improvements, and effective training (OTS' SMAART Compliance Program Components)?

Oversight by the Board of Directors

Questionnaire

- | | Yes | No |
|--|--------------------------|--------------------------|
| • Does the board approve and note in its minutes the establishment and maintenance of a written compliance program designed to assure and monitor compliance with the <i>Bank Secrecy Act (BSA)</i> (31 CFR Part 103 and 12 CFR 563.177 and 563.180)?..... | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board ensure that the BSA program includes the following at a minimum?. | | |
| — a system of internal controls? | <input type="checkbox"/> | <input type="checkbox"/> |
| — daily coordination and monitoring by a designated individual? | <input type="checkbox"/> | <input type="checkbox"/> |
| — independent testing of compliance? | <input type="checkbox"/> | <input type="checkbox"/> |
| — training for appropriate personnel? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>Truth in Lending Act and Regulation Z</i> (12 CFR Part 226)? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy and comprehensive procedures for implementing the <i>Real Estate Settlement Procedures Act and Regulation X</i> , including explanation of the coverage of the regulation, exemptions, disclosure requirements, Section 8 prohibitions and other relevant requirements (24 CFR 3500)? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy implementing the <i>Home Mortgage Disclosure Act and Regulation C</i> (12 CFR Part 203)? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>National Flood Insurance Act and OTS regulation</i> (12 CFR 572)? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>Equal Credit Opportunity Act and Regulation B</i> (12 CFR 202)? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>Fair Housing Act</i> (42 USC 3601 et seq.) and implementing HUD regulations (24 CFR 100 et. seq.) and OTS's non-discrimination regulations at 12 CFR 528.9? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>Electronic Fund Transfer Act and Regulation E</i> (12 CFR Part 205)? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>Expedited Funds Availability Act (Regulation CC at 12 CFR Part 229)</i> ? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>Truth and Savings Act and Regulation DD</i> and establish procedures addressing relevant activities (12 CFR Part 230)? | <input type="checkbox"/> | <input type="checkbox"/> |
| • Did the board adopt a policy for implementing the <i>CRA Sunshine</i> regulations (12 CFR Part 533)? | <input type="checkbox"/> | <input type="checkbox"/> |

Exam Date: _____

Prepared By: _____

Reviewed By: _____

Docket #: _____

Oversight by the Board of Directors

Questionnaire

Yes No

- Did the board adopt a policy ensuring that insurance or annuity sales activities meet enumerated regulatory obligations, institutional standards, and customer service (12 CFR 536)?

Comments

APPLICABILITY OF SELECTED SARBANES-OXLEY ACT REQUIREMENTS TO FINANCIAL INSTITUTIONS

Note: Institutions that meet more than one audit category should default to the first listed category (highest category in the hierarchy established in this chart.) For example, a public company that is also subject to FDICIA would be required to comply with all titles in Sarbanes-Oxley and default to the public company category.

Institution's Audit Category	Title II – Auditor Independence ¹	Title III – Corporate Responsibility ¹	Title IV – Enhanced Financial Disclosure ¹
Public companies ²	<u>Required</u> ¹	<u>Required</u> ¹	<u>Required</u> ¹
FDICIA required audits ³	Institutions are <u>required</u> to comply with Sections 201, 202, 203, and 206. Section 204 does not apply under the existing audit standards, but the FDIC may amend Part 363 to encompass standards that mirror Section 204. ^{6,7}	Institutions are <u>not required</u> to comply with Section 301; however, they must have an audit committee that is independent of management. Institutions are <u>not required</u> to comply with Section 302. Institutions are <u>not required</u> to comply with Section 303 but it is an unsafe and unsound practice to exercise improper influence on the conduct of an audit. ⁷	Institutions are <u>not required</u> to comply with Sections 401, 402, 404, and 406. However, the FDIC may amend Part 363 to require compliance with those sections. Institutions are <u>not required</u> to comply with 407; however, institutions with more than \$3 billion in assets are <u>required</u> to have at least two members of the audit committee with banking or related financial management expertise. The audit committee must have access to its own outside counsel. ⁷ When subject to both Section 404 and FDICIA requirements, institutions may chose to prepare one report to meet both requirements or separate reports for the FDIC and SEC. ⁸
OTS required audits ⁴	Independent public accountants are <u>required</u> to meet the independence requirements and interpretations of the SEC and its staff. ⁹	Institutions are <u>encouraged</u> to periodically review their policies and procedures relating to corporate governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources. ¹⁰	Institutions are <u>encouraged</u> to periodically review their policies and procedures relating to corporate governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources. ¹⁰

Footnotes are on page 6.

Highlights of Selected Sarbanes-Oxley Act Requirements are on pages 3-5.

Institution's Audit Category	Title II – Auditor Independence ¹	Title III – Corporate Responsibility ¹	Title IV – Enhanced Financial Disclosure ¹
<p>All other audits ⁵ - supervised by OTS, FRB, or OCC.</p>	<p>An institution <u>may be required</u> by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. If warranted for safety and soundness reasons, the institution's primary federal regulator <u>may require</u> that the institution and its independent public accountant comply with the auditor independence requirements of Section 201. ^{6,9}</p>	<p>Compliance <u>may be required</u>. If not so required, institutions are <u>encouraged</u> to periodically review their policies and procedures relating to corporate governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources. ¹⁰</p>	<p>Institutions are <u>encouraged</u> to periodically review their policies and procedures relating to corporate governance, internal controls, and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources. ¹⁰</p>
<p>All other audits ⁵ - supervised by FDIC.</p>	<p>Compliance <u>not required</u>. However, institutions are <u>encouraged</u> to follow the internal audit outsourcing prohibition in Section 201, audit partner rotation and "time out" periods similar to Section 203, institute auditor reporting practices similar to Section 204, and to comply with the conflicts of interest requirements in Section 206 given the institution's size, complexity, and risk profile. ⁷</p>	<p>Compliance <u>not required</u>. However, institutions are <u>encouraged</u> to establish an audit committee consisting entirely of outside directors, similar to Section 301, <u>asked to consider</u> implementing Section 302, and <u>strongly encouraged</u> to comply with Section 303 (improper influence over external auditing work). ⁷</p>	<p>Institutions are <u>encouraged</u> to implement to the extent feasible given the institution's size, complexity, and risk profile. Institutions are <u>encouraged</u> to implement Sections 401, 404, and 406, and <u>continue to comply</u> with Section 402 (Regulation O). ⁷</p>

Footnotes are on page 6.

Highlights of Selected Sarbanes-Oxley Act Requirements are on pages 3-5.

HIGHLIGHTS OF SELECTED SARBANES-OXLEY ACT REQUIREMENTS

Title II – Auditor Independence

Section 201: Services outside the scope of practice of auditors

- Prohibits the external auditor from providing specified nonaudit services (impermissible nonaudit services) contemporaneously with the external audit. Impermissible nonaudit services include:
 1. Bookkeeping or other services.
 2. Systems design and implementation.
 3. Appraisal or valuation services.
 4. Actuarial services.
 5. Internal audit outsourcing services.
 6. Management functions or human resources.
 7. Broker/dealer, investment advisor or investment banking services.
 8. Legal services.
 9. Expert services unrelated to the audit.
 10. Other services, as the Board deems impermissible.

Section 202: Pre-approval requirements

- Audit committee must preapprove all services that are not prohibited that the external auditor provides, including audit, tax services, and other permissible nonaudit services. Some institutions may not have an audit committee, but would instead use the board of directors.

Section 203: Audit partner rotation

- The lead or coordinating audit partner and the reviewing partner rotate off the audit every five years with a five-year “time out.” Other significant partners subject to seven-year rotations with two-year “time outs.”

Section 204: Auditor reports to the audit committee

- The external auditor must report the following to the company’s audit committee:
 - Critical accounting policies and practices;
 - Alternative accounting treatments under GAAP for material items, including:
 - ♦ The ramifications of the use of alternative treatments, and
 - ♦ The treatment preferred by the auditors; and
 - Other material communications between the auditor and management.

Section 206: Conflicts of interest

- A registered public accounting firm may not perform an audit for an institution if a person in a financial oversight role of the issuer (e.g., CEO, controller, CFO, or chief accounting officer, etc.) was a member of the audit engagement team (> 10 hours) of the issuer during a one-year “cooling off” period prior to initiation of the new audit.

Section 208 Audit Disclosures

- Fee disclosures grouped into the following four categories:
 - Audit fees.
 - Audit-related fees (e.g. employee benefit plan audits, merger and acquisition due diligence, etc.).
 - Tax fees.
 - All other fees.
- Qualitative disclosure of services provided.

Title III - Corporate responsibility

Section 301: Public company audit committees

- Audit Committee vested with responsibility for the appointment, compensation, and oversight of the external audit firm.
- All members of the audit committee must be a member of the board of directors and be independent. The institution must fund the committee adequately and the committee must be able to hire independent counsel and other advisors.

Section 302: Certifications

- Each annual report and quarterly report must include various certifications by the CEO and CFO:
 - That the financial statements and information “fairly present in all material respects the financial condition and results of operations...”
 - That they are responsible for establishing and maintaining internal controls.

Section 303: Improper Influence on Conduct of Audits

- Prohibits any officer or director (or anyone under their direction) from taking any action to fraudulently mislead an auditor for the purpose of rendering a financial statement that is materially misleading.

Title IV - Enhanced financial disclosure

Section 401: Disclosures in periodic reports

- Financial reports must reflect all material correcting adjustments.
- Annual and quarterly reports must disclose material off-balance-sheet transactions and other relationships with unconsolidated entities.

Section 402: Enhanced Conflict of Interest Provisions

- Limits personal loans to directors and executive officers.

Section 404: Management assessment of internal controls

- Annual reports must contain an internal control report.
 - Must disclose material weakness(es)
 - Management **cannot** conclude internal controls are effective if material weakness(es) exist.
- Can issue one combined report or separate FDICIA and SOX §404 reports.
- Internal control report that meets Part 363 may in some instances be filed with the SEC. Part 363 (FDICIA) requires:
 - A statement of management’s responsibility for preparing the institution’s annual financial

statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness.

— Management’s assessments of:

- ♦ The effectiveness of the institution’s internal control structure and procedures for financial reporting as of the end of the fiscal year, and
- ♦ The institution’s compliance with the designated safety and soundness laws and regulations during the fiscal year.

Section 406: Code of ethics for senior financial officers

- Requires that period reports disclose whether the issuer has adopted a code of ethics for senior officers, and if not, why not.
- Requires disclosure of any changes or waivers of the code of ethics.

Section 407: Disclosure of audit committee financial expert

- Periodic reports must disclose whether the audit committee has at least one member who is a “financial expert” (and identify).

Section 906: Certifications

- Each annual report and quarterly report must include a certification by senior corporate officers:
 - That the financial statements and information “fairly present in all material respects the financial condition and results of operations...”
- Note that this certification is in addition to the one required in Section 302. Section 906 is an amendment to the federal criminal law.

Footnotes

- ¹ Highlights of Selected Sarbanes-Oxley Act Requirements (Pages 3-5 of this document).
- ² Public companies: Banks, savings associations, and holding companies that have a class of securities registered with either the SEC or the federal banking agencies (including OTS) under Section 12 of the Securities Exchange Act of 1934 or are required to file reports with the SEC under Section 15(d) of that Act (commonly referred to as “public companies”); or, file with OTS pursuant to a reporting obligation under Section 563g.18, and, are required to have an external audit.
- ³ FDICIA required audits: Banks and savings associations with assets of \$500 million or more that are subject to the FDIC’s external audit and reporting requirements under 12 CFR Part 363.
- ⁴ OTS required audits: Savings associations and savings association holding companies required by OTS to have an audit pursuant to 12 CFR 562. Includes audits of:
- Savings associations with composite CAMELS rating of 3, 4, or 5;
 - Savings association holding companies that control savings association subsidiary(ies) with aggregate consolidated assets of \$500 million or more;
 - *De novo* savings associations; and
 - Other audits deemed necessary for safety and soundness reasons.
- ⁵ All other audits include: Banks, savings associations, and holding companies that are (1) required to have an audit by another law or regulation, an order, or another supervisory action, warranted for safety and soundness reasons; and (2) not required to have an external audit, but do so.
- ⁶ Interagency Policy Statement on the Internal Audit Function and Its Outsourcing (March 17, 2003).
- ⁷ FDIC Financial Institution Letter (FIL) – 17 – 2003, Corporate Governance, Audits and Reporting Requirements (March 5, 2003).
- ⁸ SEC's Final Rule Discussing Reports on Internal Control That May Satisfy Both SEC Requirements and FDIC Part 363 Requirements, OTS CEO Letter No. 180 (August 21, 2003).
- ⁹ Section 102 of the Sarbanes-Oxley Act requires audits of public companies to be performed by PCAOB “registered” accountants. This requirement does not apply to nonpublic companies. Auditors of nonpublic institutions must follow the independence standards identified in the AICPA Code of Professional Conduct.
- ¹⁰ Joint Interagency (OTS, FRB, OCC) Statement on Application of Recent Corporate Governance Initiatives to Nonpublic Banking Organizations, OTS CEO Letter No. 174 (May 5, 2003).