



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF
BANKING
SUPERVISION
AND
REGULATION

SR 03-8
May 5, 2003

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE
SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL
RESERVE BANK AND TO EACH DOMESTIC BANKING
ORGANIZATION SUPERVISED BY THE FEDERAL RESERVE
SUBJECT: Statement on Application of Recent Corporate Governance Initiatives to
Non-Public Banking Organizations

The Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the agencies) issued the attached *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations* on May 5, 2003. The interagency statement responds to questions that the agencies have received as to whether the agencies expect small, non-public banking organizations to comply with the Sarbanes-Oxley Act and the recent corporate governance proposals of the New York Stock Exchange (NYSE) and the NASDAQ.

As a general matter, the Sarbanes-Oxley Act, with its detailed standards designed to improve corporate governance, financial disclosures, and auditing relationships, only applies directly to public companies, including public banking organizations. Public banking organizations are those that have a class of securities registered or are required to file reports under the Securities Exchange Act of 1934. The proposed changes to the NYSE and NASDAQ listing standards, which set new detailed standards related to board composition, director independence, audit committees, and other corporate governance standards, apply to public banking organizations listed on these exchanges.¹ The FDIC issued guidance earlier this year addressing the interplay between the Sarbanes-Oxley Act and Part 363 of the FDIC's regulations, which applies to all insured depository institutions with \$500 million or more in assets.²

By issuing the attached interagency statement, the agencies reiterate their long-standing endorsement, through regulation and guidance, of sound corporate governance and auditing policies and practices for all banking organizations under their supervision. Our regulatory approach, as well as the approach adopted by Congress in the Sarbanes-Oxley Act, has sought to balance the goal of strong corporate governance with the recognition that smaller, non-public banking organizations typically have fewer resources and less complex operations than public organizations.

Consistent with these approaches, the agencies do not expect to take steps to generally apply the board composition, director independence, audit committee, auditor independence and other corporate governance requirements of the Sarbanes-Oxley Act or NYSE and NASDAQ proposals to non-public organizations that are not otherwise subject to them. Rather, the attached statement encourages non-public banking organizations to review their policies and procedures relating to corporate governance and auditing to ensure that they are consistent with applicable law, regulations, and supervisory guidance. Banking organizations should also make sure that their corporate governance and auditing policies and practices remain appropriate in light of their size, operations, and resources. The agencies also are advising such banking organizations that their standards and practices will continue to be subject to supervisory review and that appropriate corrective supervisory action will be taken if deficiencies are noted.

Reserve Banks are asked to distribute this SR letter and the attached interagency guidance to all state member banks and bank holding companies in their districts, as well as to their examination staffs. Questions pertaining to this letter and the attached interagency guidance should be directed to Barbara J. Bouchard, Assistant Director, (202) 452-3072, or Arleen E. Lustig, Supervisory Financial Analyst, (202) 452-2987.

Richard Spillenkothen
Director

Attachment

Cross Reference: SR letter 02-20

Notes:

1. In October 2002, the Federal Reserve issued SR letter 02-20, The Sarbanes-Oxley Act of 2002 (October 29, 2002), describing relevant provisions of the Act and the need for public banking organizations to comply with the law and any implementing regulations issued by the Securities and Exchange Commission. The 2002 SR letter did not address the Federal Reserve's expectations regarding compliance with the laws and the SEC's regulations by small, non-public banking organizations.
2. See FDIC FIL 17-2003 (Corporate Governance, Audits, and Reporting Requirements), Attachment II, March 5, 2003.

**Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency
Office of Thrift Supervision**

**Statement on Application of Recent Corporate Governance Initiatives To
Non-Public Banking Organizations**

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act includes a number of provisions designed to improve the corporate governance, financial disclosures and auditing relationships of public companies, including public banking organizations.¹ Banking organizations are directly subject to the Sarbanes-Oxley Act if they have a class of securities registered or they are required to file reports under the Securities Exchange Act of 1934 (public banking organizations). The New York Stock Exchange (NYSE) and NASDAQ also have proposed changes to their listing standards that would impose certain additional board composition, director independence, audit committee, and other corporate governance requirements on public companies listed on those exchanges.

The Federal Reserve Board, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (the agencies) have received questions concerning whether the agencies intend to require banking organizations that are not public companies to comply with the provisions of the Sarbanes-Oxley Act or the proposed NYSE and NASDAQ listing standards. In addressing issues concerning the Sarbanes-Oxley Act, it is useful to group institutions into the following three categories:

Public Banking Organizations:² The Sarbanes-Oxley Act applies to public companies and, accordingly, public banking organizations must comply with its provisions and implementing regulations. Public banking organizations that are listed on the NYSE and NASDAQ also must comply with the listing requirements of those exchanges.

Large Banking Organizations: All insured depository institutions that have assets of \$500 million or more, whether or not they are public companies, are subject to the provisions of Section 36 of the Federal Deposit Insurance Act (12 U.S.C. 1831m) and the FDIC's implementing regulations and guidelines (12 CFR Part 363). Section 36 and Part 363 require an annual management report, and impose annual auditing and attestation, and audit committee requirements on covered depository institutions. Part 363 allows the holding company of a covered insured depository institution to fulfill these requirements for the institution. In addition, the FDIC's implementing guidelines reference and incorporate the

¹ For purposes of this statement, banking organizations include national banks, state member banks, savings associations, and bank and saving and loan holding companies.

² Non-public banking organizations that are subsidiaries of public organizations may be subject to some provisions of the Sarbanes-Oxley Act through their parent companies.

SEC's requirements and interpretations concerning auditor independence.³ As a result certain provisions of the Sarbanes-Oxley Act relating to auditor independence are applied to institutions that are covered by the FDIC's guidelines.⁴

Small, Non-Public Banking Organizations: Non-public institutions that have less than \$500 million in assets are not subject to the Sarbanes-Oxley Act, the NYSE and NASDAQ proposals, or Part 363 of the FDIC's regulations.

The agencies have long endorsed sound corporate governance practices and have encouraged all banking organizations to internally review their operating practices and procedures to ensure that appropriate controls, disclosures, and operations are in effect. Existing banking laws, regulations and guidelines, moreover, already require or encourage all banking organizations, whether or not they are public companies, to adhere to corporate governance and auditing practices that are similar in many respects to those reflected in the Sarbanes-Oxley Act and exchange proposals. For example:

- The Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations (September 1999) encourages all institutions to have their financial statements audited annually by an independent public accountant and to have an audit committee composed of directors that are independent of management.
- The Interagency Policy Statement on the Internal Audit Function and its Outsourcing (March 2003) encourages all institutions to adhere to the restriction in Section 201 of the Sarbanes-Oxley Act on the use of the same firm for both external audit and internal audit functions. The Policy Statement also discusses the important role an institution's audit committee should play in approving all audit and non-audit services provided by the institution's external auditor and in analyzing the potential impact of any non-audit services on the external auditor's independence.
- Federal banking laws require that depository institutions file Reports of Condition and Income (Call Reports and Thrift Financial Reports) that:
 - Are certified as true and correct by a duly authorized officer and at least two, or in some cases three, directors;
 - Are prepared in accordance with accounting principles that are at least as stringent as generally accepted accounting principles; and
 - Disclose the institution's off-balance sheet assets and liabilities.

³ The FDIC issued guidance for insured depository institutions with total assets of \$500 million or more concerning the potential overlap between certain provisions of the Sarbanes-Oxley Act and the FDIC's Part 363 regulations and guidelines. See FDIC FIL 17-2003 (Corporate Governance, Audits, and Reporting Requirements), Attachment II, March 5, 2003.

⁴ In particular, the following Sarbanes-Oxley Act provisions apply to insured depository institutions with assets of \$500 million or more by reason of the FDIC guidelines: section 201 (prohibiting the performance of certain nonaudit services contemporaneously with a mandated audit); section 202 (requiring preapproval of certain nonaudit services); section 203 (mandating audit partner rotation); and section 206 (prohibiting certain conflicts of interest).

- Federal banking law and Regulation O (12 CFR Part 215) strictly control the ability of depository institutions to extend credit to directors and executive officers of the institution and its affiliates.

The agencies continue to believe that supervisory responses should be appropriate to the size, complexity, risks, and resources of different banking organizations. Our regulatory approach, as well as the approach adopted by Congress in the Sarbanes-Oxley Act, has sought to balance the goal of strong corporate governance with the recognition that smaller, non-public banking organizations typically have fewer resources and less complex operations than public organizations.

Consistent with these approaches, the agencies do not expect to take steps to apply the board composition, director independence, audit committee, auditor independence and other corporate governance requirements of the Sarbanes-Oxley Act or NYSE and NASDAQ proposals generally to non-public banking organizations that are not otherwise subject to them. The agencies, however, encourage all non-public banking organizations 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 organization's size, operations, and resources.

The agencies also will continue to assess a banking organization's policies and procedures for corporate governance, internal controls, and auditing during the supervisory process and may take appropriate supervisory action if information indicates that there are deficiencies or weaknesses in these areas inconsistent with sound corporate governance practices or safety and soundness considerations.

In addition, the agencies will continue to periodically review their existing rules, guidelines and standards, and will propose revisions to these rules, guidelines and standards as appropriate to reflect and reaffirm the important duties and responsibilities that the directors and executive officers of banking organizations have in ensuring their institutions are operated in a safe and sound manner.