



Corporate Governance Hot Buttons In Today's Regulatory Environment

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Who We Are

Luse Gorman, PC is a Washington, D.C. based law firm that specializes in representing community banks and other financial institutions.

We are a national leader in representing community banks in mergers and acquisitions, capital raising transactions, corporate governance, executive compensation, regulatory and enforcement and general corporate and securities law.

We represent over 250 financial institutions nationwide. Most are community banks ranging from \$100 million to \$20 billion in assets.

Who We Are

- Top 10 law firm in mergers and acquisitions every year since 2001
 - No. 1 in 2009, 2011, 2012 and 2015
- No. 1 law firm nationally in community bank capital raising transactions since 2000
- Largest practice group nationally dedicated exclusively to representing financial institutions
 - 25 Attorneys, including 5 attorneys specializing in executive compensation/employee benefits
 - Represent 250+ financial institutions; 100+ mutual institutions; 90+ SEC reporting companies

Agenda for Discussion

- Gold Standard of Governance
- Who Sets the Standards?
- Evolving Expectations
- Current Governance Issues

The Gold Standard

Who Generally has “Gold Standard” Practices

Company that is:

- SEC reporting, *and*
- NYSE listed, *or*
- NASDAQ Capital Market (or better) traded, *and*
- Russell 3000 (or better), *and*
- Federally insured depository subsidiary, *and*
- At least 50% institutionally held

Who Generally has “Gold Standard” Practices

Why?

Because they have to or face delisting, adverse vote consequences or stockholder action

Are their practices *better* than non-public and mutual banking companies?

Yes, generally, and, sometimes, by a large measure

Why?

Historically, federal and state banking regulators have not cared much about it (as evidenced by lack of requirements) but that lack of care/focus has changed

Evolving “Expectations”

The Old Reality

- CEO dominated company and Board decisions
- Board rarely challenged CEO
- Board functioned more as an advisor to CEO
- Board responded to corporate emergencies
- Succession planning was limited to an emergency plan
- As a result, “governance” was an afterthought

The New Reality

- Expectations have increased (again):
 - Began with Sarbanes-Oxley, intensified with Dodd-Frank
 - Courts, investors, legislators and regulators are more focused and engaged on governance issues
 - Rise of “Governance Experts”: Institutional Shareholder Services (ISS), Glass Lewis, others
 - Regulators, burned by bank failures, now get it
 - Rise of “enterprise risk management” and “risk management culture”
- “Best practices” evolves every year - ISS and Glass Lewis typically revise base standards every year, FDIC issued new guidance in April 2016 supplementing old guidance

Today's Expectations for Board

- Will be engaged in development of strategic plan
- Will actively monitor management's execution of business plan
- Will show good faith efforts to ensure compliance
- Will continually assess risk tolerance and maintain robust enterprise risk management systems
- Will have independent Board and key committees
- Active Audit, Compliance and Compensation committees
- Will assess "independence" at least annually
- Will engage independent compensation consultants
- Robust vendor selection, management and monitoring

Where Do Expectations Come From?

- Very little required by statute, regulation or court-made law regarding corporate governance or best practices
- At most, law and regulation may address charter and bylaw provisions and board delegation matters
- Sources of Expectations:
 - NYSE and NASDAQ listing requirements
 - NACD
 - FDIC, OCC, FRB handbooks and SEC regulations
 - Large pension funds (CalPers, CalSTRS, NY, FL)
 - Proxy Advisory firms (ISS, Glass Lewis)
 - International (OECD, BIS, Basel)
- ISS is typically leading edge and most influential U.S. voice

Where Do Expectations Come From?

Most complete/influential resources for community banks:

ISS: “United States, Summary Proxy Voting Guidelines, 2016 Benchmark Policy Recommendations” and ISS “Quickscore” Guidelines

Covers all of ISS’ expectations in determining its vote recommendations, including governance, compensation practices, social and environmental issues (71 pages)

FDIC: “Community Bank Director’s Guide to Corporate Governance: 21st Century Reflections on the FDIC Pocket Guide for Directors”

Just issued April 2016, supplements old pocket guide

Role and Responsibilities of the Board

- Duty of Care:
 - Act thoughtfully
 - Based on analysis of all reasonably available information
- Duty of Loyalty:
 - Act independently
 - Free of conflicting interests

Subsidiary duties:

- Confidentiality
- Disclosure of conflicts of interests or possible conflicts
- Candor when communicating with stakeholders

Role and Responsibilities of Board

Almost every source or guidance regarding the role of the Board says the same thing:

Business affairs are managed under the direction of and not by the Board of Directors:

Management, not Board, is responsible for managing the day-to-day operations

Fundamental role of Board is to oversee management by monitoring performance as compared to business plan and in compliance with policies and law

Remember: NIFO – Nose In, Fingers Out

Role and Responsibilities of the Board

Regulatory view of primary responsibilities of Board:

- Selecting, evaluating, compensating competent management
- Reviewing and approving long and short-term strategic business plans
- Reviewing and approving operating policies and procedures
- Monitoring operations and performance against laws, plans and policies (i.e., oversight obligation)
- Meeting credit needs of community

(Source: FDIC Guide for Directors)

Responsibilities of Board – Plain English

- Make sure you have adequate policies and systems in place
- Be skeptical and diligent
- Ask tough (sometimes basic) questions
- Understand the answers (or ask again)
- You may rely on:
 - Experts (attorneys, accountants, financial advisors), management and employees
 - Reliance must be in good faith and have reasonable basis
- Bottom line: get the information that a reasonable person would need to make an informed decision

Role and Responsibilities of the Board

Failure in oversight occurs when:

- Failure to have plans, policies and reporting systems in place (including governance policies and systems)
 - Board intentionally (or grossly) fails to act in face of a known duty to act, demonstrating a conscious disregard for its fiduciary duties (*i.e.*, ignoring “red flags”)
- ❖ **Practice Tip:** Regulatory criticisms in examination reports (MRAs) are “red flags” deserving of special Board attention

FDIC Guidance on Creating “Ethics Culture”

At the very least, Board needs to have policies which cover:

- Safeguarding confidential information
- Integrity of records
- Strong internal controls
- Candor in dealing with regulators, auditors and advisors
- Avoidance of self-dealing and acceptance of favors
- Observation of laws and regulations
- Implementing back-ground checks
- Internal auditor monitoring of conduct and ethics
- Reporting questionable activity
- Periodic training, acknowledgement and updating of policies

Minimum Best Governance Practices

Banks should, at the very least, have or do the following:

- Annually update strategic business plan
- Board executive sessions (at least 2x annually)
- Clawback compensation policies
- Majority of “independent” board members
- Annual “independence” testing and board review
- Independent key committees (Audit, Comp, Nominating)
- Independent compensation consultants and annual review
- Risk assessment of all incentive compensation
- Whistleblower hotline and protections
- Written corporate governance guidelines
- Code of ethics/conduct (applicable to Board as well)
- Annual risk assessments
- Written charters for all key committees

Current Governance Issues Regulatory and Public Companies

Current Governance Issues - Regulatory

Enterprise Risk Management Systems:

- Integration of risk management and compliance systems into overall “enterprise risk management”
- Board should establish risk management system with accountability and designated “Chief Risk Officer”
- Chief Risk Officer should not be involved in business operations or decisions (i.e. cannot be reviewing own work)
- Board should assess and establish “risk tolerance” in writing, taking into account regulatory environment, long-term interests, risk exposure and realistic ability to manage risks
- Should include how risk and compliance with policies will be monitored and updated
- Should demonstrate active review of critical operating policies and procedures, record of annual review and approval and response to changes (regulatory and market)
- OCC Guidelines Establishing Heightened Standards (\$50B banks)

Current Governance Issues - Regulatory

Consumer Compliance Systems:

- Long shadow of CFPB has caused other regulators to act more quickly and forcefully in area of consumer compliance
- More regulatory monitoring and scrutiny of consumer complaints and mitigation efforts
- Fair Lending, HMDA data and CRA
- UDAAP enforcement actions at all time high - direct result of new consumer bias by regulators (driven by CFBP)
- Systems should address consumer compliant and resolution logs
- System should designate compliance officer with authority to cross departments, make corrections and with accountability
- Systems should monitor and identify possible problems and “unfairness” to consumers before they happen
- Systems should address periodic review of disclosures and training

Current Governance Issues - Regulatory

Vendor Risk Management Systems:

- “Know your vendor” – can no longer “assume” vendor is compliant, must demonstrate diligence procedures in writing
- Written policies regarding diligence and monitoring now required
- Must assess potential impact of vendor relationship on customers, including access to or use of customer information
- Must assess extent to which vendor activities are subject to specific laws and regulations (e.g., BSA/AML, fiduciary rules)
- Must detail selection, assessment and oversight process
- Regulatory expectation is that Board (or committee) will be responsible for overseeing third-party risk management
- Cannot “blame” third-party for non-compliance, buck stops with the Board/bank and it must prove it had reason to believe vendor’s abilities and compliance

Current Governance Issues - Regulatory

Cyber/Data Security:

- Government-wide emphasis
- New cyber security assessment tools at FDIC and FFIEC (should demonstrate that bank has done assessment)
- Focus is not just on “security” of data and systems but preparedness and contingency plans in aftermath of breach
- Need to understand role and contractual liability of/to vendors
- Need to understand cyber insurance policies and limitations:
 - Cyber security insurance is developing market
 - Most commercial policies exclude data breaches from coverage
 - Underwriting process can help identify problems
- Many larger institutions considering Board members with cyber security and/or technology experience
- Regulators now expect Board level attention to address concerns and preparedness

Current Governance Issues - Regulatory

BSA/AML Compliance:

- Still being focused upon
- Program must be written and address (at a minimum):
 1. Internal controls to assure ongoing compliance
 2. Independent testing
 3. Designation of responsible individual(s)
 4. On-going training
- Violations occur if 4 pillars are not maintained or failure to correct MRA related to BSA/AML
- Violations result in mandatory C&D
- System must also include Customer Identification Program (CIP) with risk-based procedures which demonstrate “reasonable belief” of customers true identity

Current Governance Issues – Public Company

Problematic Pay Practices:

- Pay not aligned with performance
- Pay promoting excessive risk taking (mitigated by clawback and stockholding guidelines)
- Multi-year guaranteed bonuses
- Options repricing or backdating
- CIC payments over 3x (base and certain bonuses)*
- Single trigger CIC payments*
- Excessive perks
- 280G tax gross-ups*
- Insufficient executive compensation disclosure
- Single or common performance metrics for incentive plans
- Disproportionate SERPs

* Be careful with new or amended employment or CIC agreements, legacy agreements get a “pass” but not new or amended ones

Current Governance Issues – Public Company

Proxy Access:

- Stockholder nominations through company's proxy material (only Board's nominees currently are included)
- Court overturned SEC proposal to allow stockholders not seeking control and owning 1%-5% for 1 year, to nominate at least one director, and, in aggregate, up to 25% of Board
- SEC stockholder proposal rule amended to allow proposals relating to proxy access – “private ordering”
 - Stockholder owning \$2,000 for 1 year can submit “proxy access proposal”
 - Proxy advisory firms likely to support proxy access proposals

Current Governance Issues – Public Company

CEO Pay Ratio Disclosure Rules:

Dodd-Frank required SEC to adopt rule requiring annual disclosure of:

- (A) *median* of annual *total* compensation of all *employees*, except the CEO; (B) annual total compensation of CEO; and (C) ratio of A to B
- Disclosure first required in 2018, for 2017 fiscal year
- Narrative discussion of methodologies and any material assumptions and estimates not required but permitted with other ratios that can be presented

Current Governance Issues – Public Company

Board Voting and Composition Issues:

- Declassification: annual election of all directors (not 1/3 staggered)
- Majority Voting: now common practice for many large companies, directors can be “unelected” without an alternative slate, can be done through bylaws or policy (policy typically requires tender resignation which Board can reject)
- Independent Board Chair
- Board Tenure and Succession: ISS “scrutinizes” boards where average tenure exceeds 15 years
- Board Diversity Policies: need for stated board policy on diversity and efforts to increase diversity
- Board Term Limits: some institutional investors recommending to produce board “refreshment,” GE just adopted 15 year limit, some address issue with more robust evaluation and nomination processes and “comply or explain” disclosure

Current Governance Issues – Public Company

Forum Selection Bylaws:

- Designates courts of state of incorporation (e.g., Delaware) as exclusive forum for litigation (e.g., fiduciary duties; derivative claims; merger related litigation)
- Upheld in a recent Delaware court case and Delaware statute
- Proxy advisors typically against such bylaws

Loser Pays/Fee Shifting Bylaws:

- Provides for recovery of legal fees by prevailing party in litigation regarding intra-corporate matters (i.e. fiduciary cases)
- August 2015, Delaware legislature prohibits loser pay bylaws after Delaware court upheld such bylaws in 2014
- Still questionable practice under other states that have not ruled on issue or where statutes are not clear

Other Notables

In Re Ebix case:

- Delaware case raises new questions about validity of corporate defenses established on a “cloudy day”
- Involved defensive bylaw amendments adopted after settlement

Rural Metro case:

- Delaware case which now requires extra diligence by the Board regarding conflicts of interest of investment bankers
- Board should be on the record assessing if conflicts exist and, if so, are they actionable
- All M&A engagement letters in “to be shopped” deals need to address this issue up front
- In light of automatic post-merger stockholder fiduciary litigation, should be on the record addressing the conflict issue and conduct “independent” vote by Board

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