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Financial Services Report

Corporate Governance in Banking: After 40 Years,[1] Is It Good Yet?

Over the last six years, it has never been more necessary for those managing financial institutions to frequently remind themselves what governance procedures, practices, protocols and controls are most effective to maintain the safety and soundness of the organizations they operate. Although most of the following best practices are commonly viewed as part of the accepted "good governance" landscape, for many banks they are either unheard of or voluntarily ignored. The consequences of such ignorance/inattention have never been more concerning than in the regulatory enforcement environment that we are witnessing today.

Best Practices Topical Preview

- **Robust Risk Management**
- **Meaningful Board Independence**
- **Talented Managers and Dedicated Directors**
- **Active Board Participation**
- **Liberally Utilized Formal Committees**
- **Communication (a Hallmark)**
- **Concerted Board Action (Delay and Inaction Are Unacceptable)**
- **Obsessive Recordkeeping**

Corporate Governance: A Brief History

Before delving into "good governance" and best practices for financial institutions, it is important to briefly examine the history and development of corporate governance as it affects financial institutions. The financial institution corporate governance scheme that we have today was not always in place. In fact, it has developed over the last 40 years from a few general state law notions to a broad landscape of federal and state laws and regulations, as well as stock exchange rules, supplemented by norms that call for voluntary actions and procedures.

It was not so long ago that the audacious C. Arnholt Smith, former president of San Diego-based United States National Bank (at the time the nation's 83rd-largest bank with approximately $1 billion in assets and over 60 branches) and the former president of Westgate California Corporation (a conglomerate containing a tuna packer, a cab franchise, real estate, ranching, insurance, fruit and produce packing, a silver mine and, most importantly, a posh private club and hotel resort in San Diego) was exposed by the Wall Street Journal on April 16, 1969 to be profiting from countless insider transactions with these two businesses.

The *Wall Street Journal*'s allegations led to an investigation by the Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS), among others. When the dust had settled and the smoke had cleared, the SEC charged that Smith and his associates "have been and are now employing devices, schemes and artifices to defraud, making untrue statements of material facts and omitting to state material facts . . . massive fraud . . . deceit . . . appropriation . . . [and] converting assets."[2] The SEC said Smith and his associates were on all sides of these transactions, "capitalizing on their positions as managers and controlling persons of [the bank] and [the hotel] to systematically appropriate assets for their own benefit. To camouflage their fraudulent appropriations, they

[1] About the authors: Daniel O'Rourke (Shareholder) and Cody J. Vitello (Associate) are both members of the Vedder Price Financial Institutions group. Mr. O'Rourke is a 1972 graduate of the Georgetown University Law Center and, while a student there, first encountered concepts of director liability and fiduciary duties in the banking context in a second-year "Corporations" class. Early in the semester the instructor pointed to the C. Arnholt Smith situation as a real-life fact pattern with serious conflicts of interests and other issues. The course's final examination included a Wall Street Journal article outlining the allegations against Mr. Smith by various shareholders, regulatory agencies and others, and the exam takers were asked to try Mr. Smith for the transgressions perceived and to support their findings.

[2] Herbert W. Lockwood, "Mr. San Diego": The Decline and Fall of C. Arnholt Smith, *California Journal* (April 1974) available at http://www.unz.org/Pub/CalJournal-1974apr-00125?View=PDF.

created ostensible profits for these entities."[3] In addition, the IRS cited Smith with what was then the largest tax lien in history ($22,833,933.02) and a jeopardy assessment (an assessment of additional taxes owed without the usual review procedures).

On October 18, 1973, United States National Bank was declared insolvent and the Federal Deposit Insurance Corporation (FDIC) was appointed as the bank's receiver—at the time, the largest bank failure in the country. Later, the hotel also went bankrupt. In 1979, Smith was convicted of embezzling $8.9 million.

During that same era, President Jimmy Carter nominated his close friend and campaign advisor, Bert Lance, to serve as the director of the U.S. Office of Management and Budget (OMB) in 1977. Prior to Carter's nomination, Lance served as president and chairman of Calhoun First National Bank and as president of the National Bank of Georgia. Similar to Smith before him, the public spotlight (principally through the *New York Times* and the *Washington Post*) brought Lance scrutiny from law enforcement agencies, and the Department of Justice (DOJ) charged him with misapplication of bank funds via loans to relatives and friends and with producing false financial statements. While the DOJ's charges were ultimately found meritless by a federal jury in 1980, the damage had been done and Lance was forced to resign before his first year as director of the OMB was over.

Not long after the Smith and Lance "good governance" lapses, the savings and loan crisis of the 1980s revealed additional financial institution corporate governance failures, such as misaligned incentives and insider abuse, precipitating the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). In sum, FIRREA significantly expanded the enforcement authority of the banking regulators while FDICIA significantly expanded the supervisory authority of the FDIC.

A decade later, Enron Corporation filed for bankruptcy amidst fraudulent financial reporting and accounting tactics, precipitating the Sarbanes-Oxley Act of 2002 (SOX). SOX was a direct response to poor corporate governance "characterized by conflicts of interest, self-dealing, deceptive financial reporting, inadequate disclosure, and weak oversight by boards of directors."[4]

In an effort to prevent other catastrophic failures (it has been estimated that Enron shareholders lost $63 billion as a result of its failure), SOX imposes numerous auditor and board independence requirements and requires an issuer's principal executive and financial officers to certify the accuracy of certain financial statements. Following SOX, the NYSE and NASD followed suit and fashioned similarly focused corporate governance standards.

As we now know, the real estate boom of the 2000s proved to be a bubble and, beginning in 2007, what has been termed the "Credit Crisis," the "Great Recession" and the "Subprime Mortgage Crisis" was the impetus for the failure of 460 financial institutions, as of October 2, 2012. Congress reacted by enacting widespread reform of the banking system, and in mid-2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was passed. Among many other reforms, Dodd-Frank provided for a number of new corporate governance requirements. Many of these reforms focus on compensation. For example, many firms must give their shareholders an advisory vote on executive compensation, proxy statements are required to disclose compensation as it relates to company performance, incentive compensation is further scrutinized and, more directly related to "good governance," the bifurcation of the chairman and chief executive officer roles is encouraged.

Most recently, JPMorgan Chase has been lambasted in the news for allegedly failing to adequately supervise its chief investment office located in London. The so-called "London Whale" imbroglio is expected to cause the nation's largest bank by assets to lose nearly $6 billion on a single botched trading strategy. In fact, on August 3, 2012, the *Wall Street Journal* reported that the trader responsible for the trading positions was encouraged by his superior to inflate valuations.[5] While the full effect of the London Whale is yet to be determined, those adversely affected will likely claim that the bank failed to adequately supervise and govern its chief investment office.

The ebb and flow of the regulator and the regulated having the upper hand in the financial services industry is not without its consequences. According to a 2011 article published on BankDirector.com, a mere 10 percent increase in corporate governance costs banks 50 percent more in compliance.[6] At a time when bank

[3] *Id.*

[4] Valentine V. Craig, "The Future of Banking in America: The Changing Corporate Governance Environment: Implications of the Banking Industry," *FDIC Banking Review* (2005), available at http://www.fdic.gov/bank/analytical/banking/2005jan/article4.pdf.

[5] Gregory Zuckerman and Dan Fitzpatrick, "J.P.Morgan 'Whale' Was Prodded," *The Wall Street Journal* (August 3, 2012), available at http://online.wsj.com/article/SB10000872396390443545504577565062684880158.html.

[6] See L. William Siedman, "A Progress Check on Governance Reform," BankDirector.com (June 3, 2011).

capital and earnings are all but abundant, a legitimate cost-benefit analysis must be conducted before a financial institution blindly enacts the most costly corporate governance reforms that are not outright required. This tradeoff has become so apparent that the industry has begun, once again, to successfully push back. For example, in April of 2012, Congress enacted the Jumpstart Our Business Startups Act, which reduces the cost of capital by relaxing certain SEC registration and reporting requirements. In addition, in November of 2011, the Financial Institutions Examination Fairness and Reform Act (H.R. 3461) was introduced in Congress, providing financial institutions with more ammunition, such as enhanced appeal rights, when it comes to their supervisory examinations. While H.R. 3461 is unlikely to be enacted, the message is clear: Financial institutions are not willing and cannot afford to be regulated out of existence as a result of a few highly publicized corporate governance blunders.

Best Practices and the Role of the Bank Director

Given this delicate balance between overregulated and micromanaged boards of directors and (to some minds) inept supervision, financial institutions should, at a minimum, and in some cases may have a legal obligation to, follow several key and widely accepted best practices. But first, a general overview of a bank director's role in banking business decisions is appropriate.

First, bank directors define the strategic direction of the bank. According to the Office of the Comptroller of the Currency (OCC), "[t]his entails developing and approving the bank's strategic plan, which involves an assessment of strengths, weaknesses, opportunities, and threats, an articulation of the bank's vision, and decisions about products, services, geography, etc. Providing clear direction also entails establishing specific and measurable performance goals, setting specific risk tolerances (such as acceptable concentrations by product or geography), and clearly communicating the board's expectations."[7]

Second, bank directors select management. Again, the OCC puts it this way: "The board's role is to select the right people to manage the business, to establish performance standards and compensation practices, and to hold management accountable. The board must also terminate people who are unable to meet its expectations."[8]

Finally, bank directors provide active oversight. That is, a bank director's job is not limited to merely defining the strategic direction of the bank and hiring senior personnel to follow it; directors must also monitor progress and ensure that the proper actions are being taken to reach the board's established strategic goals. This usually requires board members to regularly receive, review and act upon such information as the bank's financial results, operating metrics, audit results and other reports.

The Role of a Bank Director

- **Define the Strategic Direction of the Bank**
- **Select Management**
- **Provide Active Oversight**

To be clear, board members are not tasked with managing the bank's day-to-day operations, but they cannot bury their heads in the sand when management departs from the board's established policies, procedures and goals in such a way as to put the bank at risk.

To balance the responsibilities of effective corporate governance with regulatory and legal requirements, bank directors should primarily focus on a few best practices—proactive risk management and meaningful independence being among the most important. Effective risk management requires directors to identify the risks inherent in the businesses and processes they oversee, determine the bank's appetite for such risks and establish the appropriate procedures and protocols to manage the institution within its chosen risk tolerances. Generally, directors should identify all risks inherent in their operating activities—especially those risks that may arise in the near term, including operational, credit, market (i.e., interest rate, equity, foreign exchange and commodity risks), liquidity, legal and reputational risks. Once such risks are identified by bank management and the board, the two can work together to develop the appropriate risk tolerances given the bank's mission and business plan, which can then be memorialized in bank policies, best practices, procedures and protocols.

These concepts are only effective if they are followed. Accordingly, meaningful independence of bank boards and management is crucial to maintain effective internal controls. This does not necessarily require that external

7 Comptroller of the Currency, Executive Summary: *Corporate Governance and the Community Bank: A Regulatory Perspective*, OCC Web and Telephone Seminar (August 2005), available at http://www.occ.gov/static/past-conferences-and-seminars/cgts-final-exec-summary.pdf.

8 *Id.*

auditors or consultants be hired for oversight. Rather, banks may achieve meaningful independence by segregating board activities by using independent committees to perform the tasks of an outside auditor or other expert. Committees of independent directors (with advisors of all stripes) are just one example of a way to effectively compartmentalize and monitor a bank's business and its risks.

While proactive risk management and meaningful independence can demonstrably improve the effectiveness of any board, bank directors, as a practical matter, should also consider the following "best of the best" practices, some of which have already been mentioned above:

- Hire the best chief executive officer you can.
- Retain only the best directors on your board.
- Be as active as a board as is reasonably feasible.
    - When facing an important decision, think about the topic thoroughly, engage in deliberations and then decide.
    - Act on your decisions.
    - Record everything that occurred.
- Use committees as often as you can, formally empower and support them, and demand that they do their job.
- Talk to regulators, customers, shareholders, auditors, employees and others on a regular basis—do not rely on management.
- Sift through all of the generally accepted best practices and pick the ones that are most appropriate for your bank.
- Follow established procedures, protocols and controls.
- Record your deliberations carefully.

The time to thoughtfully consider these best practices was yesterday. In other words, it is critical for those governing financial institutions to really take charge of their bank and to learn from the hard lessons of the last 40 years. Anyone who has read to this point is not likely to be the next C. Arnholt Smith or Bert Lance, but even well-intentioned bank executives are now defendants in lawsuits brought by the FDIC, SEC and others.

If you have questions about best practices for financial institutions and how to achieve "good governance" in today's difficult regulatory environment, please contact the *Report*'s authors, Daniel O'Rourke (+1 (312) 609 7669) and Cody J. Vitello (+1 (312) 609 7816), or any other Vedder Price attorney with whom you have worked.

The authors would like to thank Daniel C. McKay II (+1 (312) 609 7762), Co-Chair of the Financial Institutions group, for his assistance with this article.

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Financial Institutions Group Members

Jeffrey C. Davis	+1 (312) 609 7524
Thomas P. Desmond	+1 (312) 609 7647
William K. Hadler	+1 (312) 609 7590
Douglas M. Hambleton	+1 (312) 609 7684
James M. Kane, Co-Chair	+1 (312) 609 7533
Jennifer Durham King	+1 (312) 609 7835
Randall M. Lending	+1 (312) 609 7564
Daniel C. McKay II, Co-Chair	+1 (312) 609 7762
James W. Morrissey	+1 (312) 609 7717
Michael A. Nemeroff	+1 (312) 609 7858
Daniel O'Rourke	+1 (312) 609 7669
Robert J. Stucker	+1 (312) 609 7606
Cody J. Vitello	+1 (312) 609 7816

VEDDER PRICE®

222 NORTH LASALLE STREET
CHICAGO, ILLINOIS 60601
+1 (312) 609 7500 | +1 (312) 609 5005 • FAX

1633 BROADWAY, 47TH FLOOR
NEW YORK, NEW YORK 10019
+1 (212) 407 7700 | +1 (212) 407 7799 • FAX

1401 I STREET NW, SUITE 1100
WASHINGTON, D.C. 20005
+1 (202) 312 3320 | +1 (202) 312 3322 • FAX

200 ALDERSGATE
LONDON EC1A 4HD
+ 44 (0)20 3440 4680 | + 44 (0)20 3440 4681 • FAX

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