



CORPORATE GOVERNANCE
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AMERICAN BANKERS ASSOCIATION
Corporate Governance for Mutuals

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AMERICAN **BANKERS** ASSOCIATION

Corporate Governance for Mutuals

I. Introduction: Articulating the Need to Focus on Governance as a Mutual

Corporate scandals, whether involving Enron, Worldcom or others, have focused widespread attention on the need for corporate governance reform. The legislative response to these scandals, in the form of the Sarbanes-Oxley Act of 2002 and its progeny have served to intensely concentrate the attention of the corporate and regulatory world on governance compliance. As a result, corporations of all types are finding a renewed interest in corporate governance issues, trying to determine whether their own structures and procedures meet the new challenges and requirements.

Although these headline-making scandals involved, and the legislative and regulatory responses are geared towards public corporations, the issues of corporate governance are applicable to non-public corporations such as mutual savings institutions. While a mutual savings institution is different in many ways from a public company, mutuals still need to be just as concerned by corporate governance issues. The following sections highlight some of the reasons that a mutual savings institution should evaluate and re-examine its corporate governance structures.

A. Professional Depositors

In addition to widely publicized scandals at public corporations, the activities of a few individuals at community-based mutual savings institutions have brought mutual corporate governance issues to the forefront of the mutual savings institution community's attention. Commonly referred to as "professional depositors," these are individuals who become depositors at mutual institutions with the primary intention of forcing changes in the governance and/or corporate structure of the mutual institution.

These are not idle ruminations, but live examples in active litigation. For example, a depositor at Spencer Savings Bank, a New Jersey-chartered mutual savings bank located in northern New Jersey ("Spencer"), filed suit in 2005 to attempt to force Spencer to provide its depositors with materials regarding the nomination of himself and another depositor to Spencer's board of directors. The complaint also accused Spencer's board of directors of corporate waste and breach of fiduciary duties. The decision, a cautionary tale underscoring the need for incorporation of careful governance procedures, is attached as Appendix A. Similarly, a depositor of First Federal Savings & Loan Association of San Rafael, California formed a committee of depositors and sought to nominate a slate of directors to promote and implement a plan of conversion of First Federal from a mutual to a stock institution.¹ In contrast, where solid governance procedures were in place, a small group of disgruntled depositor/investors were

¹ See Matthew Squire, *The Push and Pull of Depositor Activism*, 19 THRIFT INVESTOR 4 (April 2005).

unable to overturn the reasoned and documented decision of the board of directors of Westboro Bancorp, MHC (one of two decisions in [Appendix A](#)).

While it may be tempting for boards and management to dismiss professional depositors as financial mercenaries seeking their own interests at the expense of the bank, its customers and the community, the approach to board members and others is often cloaked in language that the bank itself would use – seeking board seats and actions in order to do what is in the best interests of the financial institution and its depositors. For this reason, the board of directors of a mutual institution needs to take great care with, and perhaps re-examine, the corporate governance structures and procedures of its institution. Even if new or different board members or a plan of conversion might be in the best interest of the mutual institution, it is the leadership of the mutual institution, and not a lone, self-interested professional depositor, who should make that determination. Effective corporate governance will ensure that pivotal corporate decisions are in the hands of those charged with their consideration.

B. Fiduciary Duties and Liability

Directors and officers of a bank, like directors and officers in other corporations, are in a fiduciary relationship with the bank and owe it certain fiduciary duties. A fiduciary duty is a “duty of utmost good faith, trust, confidence, and candor owed by a fiduciary ... to the beneficiary.”² The law expresses this relationship in the corporate duties of loyalty and care, which are generally encoded in the corporate law of each state. In addition, the FDIC has issued a policy statement addressing the fiduciary duties of directors and officers, and the liability attached to the failure to fulfill those duties.³

The duty of loyalty requires directors and officers of a financial institution to place the interests of the institution ahead of their own personal interests. This means that the directors and officers may not advance their own or others’ interests at the expense of the financial institution. The duty of care requires that the directors and officers of a financial institution act as prudent and diligent business persons in conducting the affairs of the institution. The key to the duty of care is the use of reasonable business judgment, based on all available information and proper deliberation, with regard to all business decisions on behalf of the institution.

Proper corporate governance is essential to the fulfillment of directors’ and officers’ fiduciary duties. The various components of an effective system of corporate governance provide the tangible evidence that management⁴ is fulfilling its fiduciary duties. For example, when the board of directors selects, monitors, and evaluates competent executive officers, it is simultaneously demonstrating good governance and fulfilling its duty of care to the institution. When a board of directors fails to institute a proper system of corporate governance, it fails to live up to its fiduciary duties to the institution. A failure of fiduciary responsibility exposes the directors and officers of an institution to potential corporate and personal liability.

² BLACK’S LAW DICTIONARY 523 (7th ed. 1999).

³ FDIC FIL 87-92, *Statement Concerning the Responsibilities of Bank Directors and Officers* (December 3, 1992).

⁴ As used in this Article, the term “management” refers to both the board of directors and the executive officers of an institution.

C. Examination and Re-examination

Another reason for a mutual savings institution to seriously consider reevaluating its corporate governance structure can be found in the approach taken by federal banking regulators to corporate governance issues. The rules and guidance, often issued collaboratively by several of the federal banking regulators, are layered because of overlapping jurisdictions. The FDIC rules apply to all FDIC insured depository institutions. The chartering entity, whether the Office of Thrift Supervision (the “OTS”) for federal mutual savings banks or the state banking commission for state chartered institutions, has its own rules and requirements. In addition, other mutual institutions have chosen to become members of the Federal Reserve System thereby adding yet another layer of regulatory requirement.

Each of the federal banking regulators emphasizes the importance of sound corporate governance within the operation of a financial institution. For example, the FDIC and OTS consider the effectiveness of corporate governance as a part of their overall examination of an institution under the CAMELS framework. These regulators consider corporate governance to be a key determinant of the overall performance of an institution.⁵ As noted by one of the past Governors while serving on the Board of Governors of the Federal Reserve System (the “FRB”), poor asset quality is often linked to weak or ineffective corporate governance.⁶

As a result, it is not surprising that federal regulators encourage all financial institutions to implement sound corporate governance policies. In fact, in the wake of the corporate scandals and Sarbanes-Oxley, the Office of the Comptroller of the Currency (the “OCC”), the FRB and the OTS have specifically reaffirmed the importance of sound corporate governance for all financial institutions, including non-public and smaller institutions. Additionally, these agencies emphasize that financial institutions are encouraged to “periodically review their policies and procedures relating to corporate governance and auditing matters.” The scope of such a review should include compliance with all applicable law, regulations and guidance. In addition, the institution should evaluate which corporate governance policies and procedures are most appropriate to its size, operations and resources.⁷

II. Sources of Mutual Corporate Governance Guidance

This section is not entitled “Mutual Corporate Governance *Requirements*”, but rather is stated in terms of guidance in order to stress the message that corporate governance of mutual savings institutions should not be approached as an exercise in compliance. There are relatively few hard and fast legal requirements addressing corporate governance structures that apply to

⁵ FDIC Risk Management Manual of Examination Policies, Part II Section 4.1: *Management*; OTS Examination Handbook, Section 310: *Management, Oversight by the Board of Directors* and Section 330: *Management: Management Assessment*.

⁶ Governor Susan Schmidt Bies, Remarks before the Annual Convention of the Arkansas Bankers Association, *Corporate Governance and Community Banks* (May 17, 2004) available at <http://www.federalreserve.gov/boarddocs/speeches/2004/200405172/default.htm>; Governor Susan Schmidt Bies, Remarks at the Federal Reserve Bank of Chicago Community Bank Directors Conference, *Corporate Governance and Risk Management at Community Banks* (August 12, 2004) available at <http://www.federalreserve.gov/boarddocs/speeches/2004/200408122/default.htm>.

⁷ FRB SR 03-8, *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations* (May 5, 2003).

mutual savings institutions. An institution that approaches a review of its corporate governance in terms of minimum compliance will find that it falls far short of what is considered effective corporate governance. While the corporate governance structures of a mutual institution, particularly internal controls, must ensure compliance with applicable law, minimum compliance with legal requirements should not be the focus or goal of any mutual institution's review of its corporate governance.⁸

Although the following sections identify the extent to which the various legal frameworks for corporate governance impose legal and regulatory requirements on mutual institutions, it is important to bear in mind that failures in effective governance may not be apparent to those outside the institution until a significant breakdown has occurred. Any breakdown in this area brings with it high costs, in the form of potential lawsuits and enforcement actions, not to mention damage to the institution's reputation. For this reason, it is highly worthwhile for a mutual institution to review its governance and assess whether its process reflects industry best practices, given its size and resources, which will provide a firm foundation for the institution.⁹

With a best practices framework in mind, it is useful to look to all available sources of guidance on corporate governance, particularly as tailored for non-public, mutual institutions. This section highlights basic governance structure provisions for federal and state chartered mutual savings institutions, the requirements of the Federal Deposit Insurance Corporation Improvement Act, Sarbanes-Oxley, and other banking regulatory guidance.

A. Federal and State Provisions Establishing Basic Governance Structure

A mutual savings institution's basic corporate governance structure is governed by its particular chartering authority whether federal or state. The federal corporate governance provisions for mutual savings institutions are primarily in the form of regulations promulgated by the OTS and may be found at 12 C.F.R. Part 544. The corporate governance of state chartered mutual thrifts varies from state to state, as each state adopts its own laws regarding mutual corporate governance.

(i) Federal Mutual Charter

Under the OTS rules, the affairs of a federal mutual thrift are managed by a board of directors composed of at least five, but not more than 15 directors. The directors are elected by the members, who may also nominate a person for election to the board of directors. The members are the depositors of the thrift. However, if a state chartered thrift with existing borrower members adopts a federal charter, those borrower members will be grandfathered in as members of the federal thrift. Members vote at annual meetings and members holding at least

⁸ See Governor Susan Schmidt Bies, Remarks before the Annual Convention of the Arkansas Bankers Association, *Corporate Governance and Community Banks* (May 17, 2004) available at <http://www.federalreserve.gov/boarddocs/speeches/2004/200405172/default.htm>; Governor Susan Schmidt Bies, Remarks at the Federal Reserve Bank of Chicago Community Bank Directors Conference, *Corporate Governance and Risk Management at Community Banks* (August 12, 2004) available at <http://www.federalreserve.gov/boarddocs/speeches/2004/200408122/default.htm>; FRB SR 03-8, *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations* (May 5, 2003); FDIC FIL 17-2003, *Corporate Governance, Audits, and Reporting Requirements* (March 5, 2003).

⁹ Id.

10% of the thrift's FDIC insured deposits may call a special meeting. Any number of members present at a meeting constitutes a quorum. Presence includes presence by proxy, as proxy voting is allowed. Each depositor member receives one vote for every \$100 of deposits or fraction thereof; grandfathered borrower members receive one vote. However, no member can receive more than 1,000 votes. Members also have the right to amend the bylaws, to communicate with other members and to inspect the corporate books and records.

A federally chartered mutual thrift may follow the corporate governance provisions described above, or they may choose to follow the corporate governance procedures of the state where their main office is located.

(ii) State Mutual Charters

The corporate governance provisions applicable to state chartered mutual savings associations will vary from state to state. In many cases they are very similar to the federal structure. That is, many states require a board of directors, which is elected by the members, who are either depositors, or depositors and borrowers. The members vote at annual meetings -- depositors receive votes in proportion to their deposits, and borrowers receive one vote. Many states also have some sort of cap on the number of votes any one borrower may receive.

Other provisions have greater variance between the states. Not all states grant members the right to call a special meeting, and among those that do, the representative percentage required to call the special meeting varies. States are also split as to granting members the right to vote by proxy; many leave it to determination in the bylaws. While a good number of states declare a quorum for any number of members present, others require some percentage to be present to establish a quorum. Some states grant members the right to amend the bylaws; others leave it up to the mutual savings association to determine in its bylaws. While a few states follow the federal model granting members communication and inspection rights, most states do not address issues of member communication and right to inspect books and records.

In addition, a few states follow a very different corporate governance structure. Rather than providing for a board of directors elected by members, these states set up a board of trustees, composed of, and elected by, a group of "corporators." Although corporators must normally be depositors, not all depositors are corporators. The corporators are a smaller group who act in the interests of the mutual savings association. The first group of corporators is approved by the state chartering authority when the mutual savings association is formed; thereafter, the corporators elect a certain number of new corporators each year.

Further information regarding mutual corporate governance provisions under state law can be found in the survey of state provisions attached as [Appendix B](#) to this Article.

B. FDICIA

Twenty years before to the more recent scandals that resulted in Sarbanes-Oxley, the savings and loan crisis of the early 1980's precipitated legislative reform addressing some of the same corporate governance issues. Section 112 of the Federal Deposit Insurance Corporation Improvement Act (the "FDICIA") addresses the need for accurate financial reporting and management's responsibility for that reporting. The requirements of Section 112 are

incorporated as Section 36 of the Federal Deposit Insurance Act and in FDIC regulations at 12 C.F.R. Part 363. The full compliment of additional reporting requirements only apply to FDIC insured institutions with over \$1 billion in total assets.¹⁰ Those institutions between \$500 million and \$1 billion in assets are required to establish an audit committee the majority of whom will be outside directors (unless a hardship is demonstrated).¹¹ Nonetheless, the FDIC has made it clear that even if an institution is not subject to the mandatory provisions of Section 36, they remain valuable corporate governance practices that all FDIC insured institutions, of whatever size, are encouraged to implement to the fullest extent practicable.¹²

Institutions subject to Section 36 of the FDIA are required to prepare and submit an annual report, sometimes referred to as the Part 363 Report, to the FDIC and their federal or State regulator. The report includes the annual financial statements prepared in accordance with generally accepted accounting principles (“GAAP”) and audited annually by an independent public accountant in accordance with generally accepted auditing standards (“GAAS”). Within the report, the chief executive and chief financial officers must sign a statement that management is responsible for preparation of the financial statements, establishment and maintenance of internal controls and procedures, and legal compliance with safety and soundness standards. In addition to establishing and maintaining internal controls and procedures, management is required to assess their effectiveness, which assessment must be included in the Part 363 Report. And finally, Section 112 of the FDICIA requires the institution to establish an audit committee composed entirely of independent outside directors, if possible, but in no case with less than a majority of independent outside directors. For those institutions with total assets of \$3 billion or more, the audit committee is required to include members with banking or financial management expertise and to have access to its own outside counsel.¹³

The requirements of Section 112 of the FDICIA, and the implications for those institutions not expressly subject to those requirements, are discussed as applicable in the following sections of this Article.

C. Sarbanes-Oxley

The provisions of Sarbanes-Oxley are directed towards public corporations, that is, corporations, including insured depository institutions, which have a class of securities registered with the Securities and Exchange Commission or the appropriate federal banking agency under Section 12 of the Securities and Exchange Act of 1934. The FDIC implements the requirements of Sarbanes-Oxley for public corporations that are insured depository institutions through Part 335 of the FDIC regulations, which incorporates all applicable SEC regulations by reference.

¹⁰ Annual Independent Audits and Reporting Requirements, 12 C.F.R. Part 363.

¹¹ 12 CFR § 363.5(a)(2).

¹² FDIC FIL 96-99, *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* (Oct. 25, 1999); FDIC FIL 21-2003, *Interagency Policy Statement on the Internal Audit Function and its Outsourcing* (March 17, 2003); Annual Independent Audits and Reporting Requirements, 12 C.F.R. Part 363.

¹³ 12 CFR § 363.5(b).

Under the present FDIC rules, non-public insured depository institutions with \$1 billion in total assets are required to comply with a number of the Sarbanes-Oxley requirements.¹⁴ Key corporate governance provisions of Sarbanes-Oxley include auditor independence, greater corporate responsibility, and enhanced financial disclosures (Titles II – IV). The OTS provides an overview of Sarbanes-Oxley corporate governance requirements at Appendix A of Section 310 of its Examination Handbook, attached to this Article as Appendix C. The requirements of Sarbanes-Oxley outlined above are more fully discussed as applicable in the following sections of this Article.

D. Other Banking Regulatory Guidance

(i) Office of Thrift Supervision

Regulatory guidance issued by the OTS applies to savings institutions, both mutual and stock, that are federally chartered. However, even state chartered mutuals may wish to consider the OTS guidance as a useful source of corporate governance best practices. A number of the issuances have been collaboratively developed with other federal banking regulators including the “Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations” issued jointly by the OTS, the OCC and the FRB. Additionally, the OTS and the FDIC, with the FRB and the OCC, issued an Interagency Policy Statement on “External Auditing Programs of Banks and Savings Associations,” and a third Interagency Policy Statement on the “Internal Audit Function and its Outsourcing.”

Section 310 of the OTS Examination Handbook addresses the responsibilities of the board of directors of a savings and loan association. Section 330 of the OTS Examination Handbook covers OTS assessment of the officers of a savings and loan association. The OTS also published a Director’s Responsibilities Guide and a Directors Guide to Management Reports as resources for directors of savings and loan associations. The standards for governance contained in the interagency statements, Sections 310 and 330 of the OTS Examination Handbook and the two Directors Guides are discussed as applicable in the following sections of this Article.

(ii) The FDIC

As noted above under the FDICIA discussion, the FDIC issued a Financial Institution Letter in 2003 that addressed the applicability of certain provision of Sarbanes-Oxley to insured institutions, in addition to discussing corporate governance practices that the FDIC encourages insured institutions to adopt as a part of a sound corporate governance structure. Two attachments to the letter address applicability of provisions of Sarbanes-Oxley and suggested best practices in corporate governance for non-public institutions. The FDIC also addresses standards for corporate governance in its Risk Management Manual of Examination Policies, Section 4.1 – Management. These sources of FDIC guidance on corporate governance are discussed as applicable in the following sections of this Article.

¹⁴ 12 CFR §§ 363.3 – 363.5. See also, FDIC FIL 17-2003, Attachment II, *Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to Insured Institutions with \$500 Million or More in Total Assets* (March 5, 2003).

III. Evaluating Existing Charter and Bylaws

The charter and bylaws of an institution generally establish the governance framework within which the institution will operate by addressing basics of governance structure. In some cases, the charter and bylaws of an institution are already the result of careful planning and forethought regarding the structures and interrelationships of the various sources of leadership authority for the institution. In others, the charter and bylaws may have been in existence unchanged for many years, leaving the original intentions of the original authors unknown.

In either case, it is a valuable exercise to reexamine the provisions of the charter and bylaws in order to determine whether these documents provide for structures and procedures, which, in the best judgment of management, facilitate effective corporate governance that is in line with a best practices approach in the post Sarbanes-Oxley corporate environment. In addition, many provisions of the charter and bylaws are dictated by the laws or regulations of the chartering authority: State laws for State-chartered mutual institutions and OTS regulations for federal mutual institutions, as discussed in Section II.A., above. Thus, a review of the charter and bylaws should also, if not first, address whether the documents are in compliance with the laws or regulations of the chartering authority. Detail regarding many of the required charter and/or bylaws provisions can be found in the survey of mutual corporate governance provisions attached as [Appendix B](#) to this Article. In all cases, the mutual institution should ensure that the provisions of its charter and bylaws are consistent with one another and do not conflict.

There are many different provisions which must or may be included in the charter and bylaws of a mutual savings institution. This Section will highlight several charter and bylaws issues that should be addressed and/or reviewed by a mutual institution in the interest of establishing corporate governance structures in line with best practices.

A. Amendment of the Charter and Bylaws

A good place to start in a review of the charter and bylaws of a mutual institution is with the method for amending the documents. In order to implement any desired changes, the documents will, of course, have to be amended.

Amendments to the bylaws of a federally chartered mutual institution must be approved by majority vote of either the members of the institution or the board of directors.¹⁵ Provisions for amendments to the bylaws of state-chartered mutual institutions vary from state to state. Arizona provides that both the members and the board may amend the bylaws. Iowa and Indiana grant the right to amend the bylaws to the board only, unless the charter provides otherwise. Alabama allows members to amend the bylaws by a majority vote, but the board must have a 2/3 vote to approve bylaws amendments. Michigan provides that the board will propose amendments, which the members adopt by majority vote. Oklahoma does not permit the board to amend the bylaws. Tennessee allows the members to adopt bylaws, which specifically deny the board the right to amend those bylaws. Several states, including California, New Jersey and New York leave bylaws amendments to determination by the bylaws themselves.¹⁶

¹⁵ 12 C.F.R. § 544.5.

¹⁶ Further detail and statutory citations are available in [Appendix B](#) to this Article.

If, after ensuring that the provisions regarding amendment comply with the legal requirements of its chartering authority, the mutual institution is left with choices as to specifics of the amendment process, it should examine the various options available, and choose from those that best fit the needs of its institution. Generally, the institution should determine who initiates recommendations for amendments, members and/or the board; who votes on the passage of amendments, members and/or the board; and what the voting requirement for passage will be, whether a majority or more than a majority (see the discussion of supermajority voting provisions, below).

B. Supermajority Voting Provisions

Most items of business submitted to a vote require approval of the measure by a majority of the directors or members. However, mutual savings associations generally have the option to require the approval of a higher percentage of members on specific questions of their choice. Recently, institutions have been seen to implement charter and bylaw provisions that impose higher voting standards for stock offerings and certain merger transactions in which the institution is not the survivor. For example, one institution requires a unanimous vote of the board of directors for a stock offering; another requires an 80% vote of approval by the incorporators for a stock offering; and one institution has set a 66% depositor vote threshold for a merger, unless the merger is approved by the board of directors. Both state and federal mutual savings associations should consider whether there is a reason to consider implementing a supermajority vote requirement for certain extraordinary transactions.

C. Classification of the Board of Directors

There are many issues involved in the election of the members of the board of directors because of the high level of responsibility granted to the board of directors for the management of a financial institution. In fact, in the opinion of the FDIC, “the continuing health, viability, and vigor of the bank are dependent upon an interested, informed and vigilant board of directors.”¹⁷ It is therefore imperative that a mutual institution attract, elect and retain high quality directors. The corporate governance provisions related to the election of the board of directors should be structured to facilitate this goal. The OTS and many states provide an alternative for board of director elections, the institution of a classified board, an approach that can lessen the disruption of board turnover and may encourage more knowledgeable board member participation.

A board that is not classified holds elections for all of the board seats at one time. A classified board of directors places only a portion of the full board up for election at any particular election. For example, a classified board might consist of nine directors, of which only three are elected per year. That means that each of the nine directors serves three-year terms. That same board holding non classified elections would elect each of the nine directors at the same election; the frequency of the election would determine the term, though often the elections are required to be annual.

¹⁷ FDIC Risk Management Manual of Examination Policies, Part II Section 4.1: *Management*.

Federally chartered mutual institutions are permitted to have a classified board, provided that directors serve one, two or three year terms and approximately one third or one half of the board is elected each year, as appropriate.¹⁸ Twenty-one states either permit or require the board of directors of mutual institutions to be classified. The remaining states are silent on the issue.¹⁹

In considering whether to institute a classified board, the mutual institution should first verify whether classification is required or permitted. If left with an option, the mutual institution should carefully consider the impact that classification will have on the board of directors. Choosing to elect only a portion of the board each year can allow for longer terms of service for the members, and possibly less frequent turnover on the board of directors. This could allow for more stability on the board and permit board members to build expertise and higher level of competence in their roles. Additionally, a classified board can limit the likelihood of success of a professional depositor of gaining control of the institution by preventing the depositor from nominating new directors to all or a majority of the board positions in any one year. The institution must also keep in mind that instituting a classified board may require a change in the number and/or terms of directors on the board.

D. Special Meetings

The members of a mutual institution generally vote on the election of directors and other corporate matters at an annual meeting of members. In addition to annual meetings, a mutual institution may provide for the possibility of special meetings of members, which are additional meetings beyond the annual meeting of members. A special meeting might be called to elect new directors or to vote on other corporate matters of particular importance ahead of the next scheduled annual meeting. When reviewing its bylaws, a mutual institution should examine whether special meetings are provided for, and if so, who is given the authority to call such a meeting.

The board of directors of a federally chartered mutual institution may call a special meeting of its members. Additionally, the members of a federally chartered mutual institution are provided with the authority to call a special meeting, provided that those members represent at least 10% of the institution's insured deposits. The procedures for calling the special meeting are to be set out in the bylaws of the mutual institution.²⁰

Most states are either silent as to the authority of mutual institution members to call special meetings or provide that the members may call special meetings as, or if, the bylaws of the institution provide. California, Missouri and Tennessee authorize the members who are the holders of at least 10% of deposits or votes to call a special meeting. Wisconsin grants the right to members holding 20% of the eligible votes. Montana and North Dakota both require the members to hold at least 25% of deposits or share accounts before they may call a special meeting.²¹

¹⁸ 12 C.F.R. § 544.5(a)(8).

¹⁹ Further detail and statutory citations are available in [Appendix B](#) to this Article.

²⁰ 12 C.F.R. § 544.5(a)(2).

²¹ Further detail and statutory citations are available in [Appendix B](#) to this Article.

In reviewing its provisions on special meetings, it is important that the charter and bylaws be consistent with the law of its chartering authority. Additionally, all mutual institutions should grant the board of directors the authority to call a special meeting of the members. As mentioned above, a special meeting of members may be used to facilitate member voting on a corporate issue when it is inconvenient or undesirable to wait for the next scheduled annual meeting of the members. If the institution is chartered by a state that is silent as to special meetings, or that leaves it to determination by the institution in its bylaws, the mutual institution should consider whether it should grant its members the right to call such a meeting, and if so, under what conditions. In making this determination, the mutual institution should bear in mind the potential that a professional depositor might wish to call a special meeting to force a vote on his or her proposed agenda, such as a conversion plan or election of new directors to the board. The institution is free to establish a minimum deposit percentage for eligibility to call a special meeting, such as the ten, twenty or even twenty-five percent minimum set by several states. In addition, the bylaws should address the procedure to be followed to call such a meeting.

E. Depositor Communications

Communications among depositors can have a large impact on the business of a mutual savings association. Depositor communications are of particular importance to mutual institutions concerned about the activities of professional depositors, who may make use of depositor communication provisions to further their efforts to bring about significant changes in governance, such as adoption of a conversion plan or election of new leadership to the board of directors. The ability, or lack thereof, of these activist depositors to communicate with other depositors is central to the success, or failure, of their efforts. This is because the activist depositor must garner enough votes from other depositors to successfully institute a proposed plan or elects his proposed directors to the board, but also because the ability of a lone depositor to nominate a director for election may be restricted, such that the cooperation of additional depositors is required even for nomination.²²

Provisions regarding communications between depositors are the mutual institution equivalent of the SEC rules governing the inclusion of security holder proposals in public company proxy materials and nomination of directors for election to the board. Nomination provisions are more specifically addressed in Section IV.A, Nominating Committee, below. The SEC rules on shareholder proposals specify who is eligible, according to the percentage of securities ownership, to submit a proposal for inclusion on the company's proxy card and subsequent presentation at a shareholders' meeting. The rules also set out deadlines for submission of a proposal and reasons that a shareholder proposal can be excluded from proxy materials.²³

Depositor Communications at Federal Mutual Savings Associations. The OTS rules specifically grant the members of federal mutual savings associations the right to communicate with one another. The requesting member must make a written request to the mutual savings association, which then has up to 14 days to respond to the request, unless the communication

²² Additional discussion of nomination of directors and the nominating committee can be found in Section IV.B., Nominating Committee.

²³ SEC Rule 14a-8 under the Securities Exchange Act of 1934.

relates to a meeting, in which case less time is allowed. The mutual savings association must either respond with the number of members of the association and the estimated cost of mailing, or by notifying the member that the communication is “improper” and returning the materials, along with an explanation of why the materials were “improper”.²⁴

Communications are considered “improper” if they: (1) are false or misleading as to any statement or omission; (2) relate to a personal grievance or seek to “further the business advantage or personal gain of the depositor”; (3) relate to any matter not significantly related to the business of the mutual savings association, or out of the control of the mutual savings association; and (4) impugn someone’s personal reputation or makes charges concerning improper, illegal, or immoral conduct, or impugns the stability and soundness of the mutual savings association.²⁵ Note that there is no provision allowing the mutual savings association to deny distribution of a communication related to “ordinary business” issues, as there is under the SEC rules.²⁶

If the communication is not improper, and the institution has provided the requesting depositor with the number of depositors and estimate cost of mailing, and in return has received the amount of the estimated costs and the appropriate number of copies of the communication, then the mutual savings association must mail the communication to all members within a certain amount of time depending on whether it relates to a meeting, or by some later date, as specified by the requesting member.²⁷

Depositor Communications at State Mutual Savings Associations. With limited exceptions, communications among depositors of state mutual savings associations are governed by state law. Most states are silent on the issue of permissible depositor communications. Among those states that address depositor communications are California, Michigan, Minnesota, Mississippi, New Jersey, Tennessee, Utah, and Virginia. Each of these states requires that the requesting member pay the costs of mailing in any case where the communication is sent to the members. California, Michigan, Minnesota, Mississippi, Utah, and Virginia require that the communication be related to questions pending or to be presented for consideration at a meeting of the members. New Jersey appears to allow member requests on any topic, but will only compel the savings association to distribute communications that are made in good faith and not detrimental to the best interests of the savings association. Each of the states involves approval of the State’s banking commissioner in the process of requesting a member communication.²⁸

Again, when considering changes to this section of its bylaws, the mutual institution should first ensure that its bylaws are consistent with the provisions of its chartering authority on depositor communications. If the chartering authority has remained silent as to depositor communications, the mutual institution should nonetheless consider addressing the topic in its bylaws bearing in mind potential professional depositor activism and also best practices employed by the public corporate community. In its rules addressing shareholder proposals, the SEC requires public companies to include certain shareholder proposals in their proxy materials,

²⁴ 12 C.F.R. §§ 544.5(a)(7) and 544.8.

²⁵ 12 C.F.R. § 544.8.

²⁶ SEC Rule 14a-8 under the Securities Exchange Act of 1934.

²⁷ 12 C.F.R. § 544.8.

²⁸ Statutory citations are available in [Appendix B](#) to this Article.

and to disclose to the SEC any proposal that is excluded, and the reasons for that exclusion.²⁹ In addition, the SEC rules governing nominating procedures require that disclosures must be made as to whether and how stockholders may nominate persons to the board of directors.³⁰ These rules were adopted after the public corporate community expressed concern over corporate director accountability and the need for greater access to the nomination process and greater ability for shareholders to exercise their rights and responsibilities.³¹

Although a mutual institution chartered by a state that neither requires nor prohibits depositor communications might choose to disallow communications altogether or perhaps leave the bylaws, like state law, silent on the entire issue, this may not be in line with a best practices approach. SEC rules requiring companies to include shareholder proposals in proxy materials under certain circumstances should cause a mutual institution to hesitate before deciding to prohibit depositor communications altogether. The SEC's emphasis on disclosure regarding shareholder proposals and the nomination process should encourage mutual institutions to address depositor communications in their bylaws, thereby adopting a clear policy on the matter.

Adopting a clear policy regarding depositor communications does not mean that the mutual institution must facilitate, or even permit all or even most proposed communications by its depositors. In establishing its policy on depositor communications, the association has a range of choices. It may permit communications subject to a process similar to that proscribed by the states that address the issue, that is, permit communications subject to board approval with payment of costs by the requesting depositor. The mutual institution might also allow communications subject to other specific restrictions, such as by topic or minimum depositor interest in the association. When establishing restrictions by topic, the OTS rules on "improper communications" and the SEC's enumerated reasons to exclude a shareholder proposal are a good potential reference source. The mutual institution should also clearly set out the process for proposing a communication that clearly defines deadlines and time limits for submissions.

IV. Committees

The board of directors of a mutual institution has a wide range of responsibilities, including selecting and retaining competent executive officers, establishing the objectives and strategies of the institution, identifying and assessing risks associated with those objectives and strategies of the institution, establishing policies and procedures for those objectives and strategies of the institution, monitoring and assessing the progress of operations, and ensuring that the institution is in compliance with applicable laws and regulations. In short, the board of directors is ultimately responsible for the oversight of the business of the mutual institution from start to finish. It is not a passive role, but one of active, knowledgeable involvement.³²

Because of the corporate scandals and other concerns, there is an increased emphasis on the accountability of the board of directors. As a result, even higher levels of board

²⁹ SEC Rule 14a-8 under the Securities Exchange Act of 1934.

³⁰ 17 C.F.R. §§ 228, 229, 240 et al.

³¹ *Id.*

³² OTS, *The Directors' Guide to Responsibilities* (Oct. 17, 2006).

responsibility and involvement in the business of the institution are expected.³³ The volume and complexity of information and decision-making expected of the boards of mutual savings institutions can be overwhelming. The establishment of committees is a common approach for dealing with the situation, enabling smaller groups of directors and officers with special expertise to manage and interpret complex information before reporting back to the entire board for decisions.³⁴

In establishing committees, the board should be aware of the risks involved in having a committee entirely composed of inside directors, such as executive officers, former executive officers, principal shareholders, and relatives. There is a danger that such committees may filter the information that they are responsible to analyze and present the performance of the institution in its most favorable light to the full board. For this reason, it is preferable to establish committees composed of a mix of inside and outside directors, as well as executive officers, so that the committee comprises a high level of expertise as well as independence.³⁵

There are various types of committees that an institution may choose to adopt. This Article will discuss audit committees and nominating committees, both of which are addressed by Sarbanes-Oxley.

A. Audit Committee

Sarbanes-Oxley requires all public companies to have an audit committee composed of independent members of the board of directors. The audit committee must be adequately funded by the public company and must be able to hire independent counsel and other advisors.³⁶ In addition, the public company must disclose whether the audit committee has at least one member who is a “financial expert.”³⁷ These requirements do not apply to mutual institutions. And, the FRB and the OTS have stated that they do not anticipate taking steps to require compliance with the audit committee requirements of Sarbanes-Oxley by non-public banking organizations.³⁸

However, mutual institutions are either required or encouraged, dependant upon their size, to have an audit committee. Only institutions with more than \$1 billion in total assets are required by the FDIC to have an audit committee. And while mutual savings institutions with fewer total assets are not strictly required by law to have an audit committee, an interagency

³³ See, OTS Press Release No. 07-065, Wednesday, Sept. 12, 2007, highlighting principles for directors as part of the announcement of OTS’s training seminar for directors: “[there are] four principles that should guide directors: integrity, independence, involvement – but not interference. . . If you are disconnected, you are simply not doing your job.”

³⁴ OTS, *The Directors’ Guide to Responsibilities* (Oct. 17, 2006).

³⁵ *Id.*

³⁶ OTS Examination Handbook, Section 310, Appendix A: *Applicability of Selected Sarbanes-Oxley Act Requirements to Financial Institutions*, attached as Appendix C to this article.

³⁷ *Id.*

³⁸ FRB SR 03-8, *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations* (May 5, 2003) available at http://www.ffiec.gov/ffiecinfobase/resources/audit/frb-srl_03_8-stat_corp_gov_initiat_nonpub_bank_org.pdf.

statement regarding external auditing programs that is specifically directed at non-public institutions insured by the FDIC encourages the establishment of audit committees.³⁹

Requirements as to the composition of the audit committee are also dependent upon size. Institutions with \$1 billion or more in total assets are required to have an audit committee composed entirely of outside directors who are independent of management.⁴⁰ Whether required or not however, the FDIC encourages all insured institutions to adopt audit committees composed entirely of outside directors who are independent of management, whenever practicable. If impracticable, the institution should try for a committee composed entirely of outside directors, and if this still poses a problem, should at least have an audit committee composed of a majority of outside directors.⁴¹ An outside director is a director who is not an officer or employee of the institution, its subsidiaries or its affiliates, and who does not have any material business dealings with the institution, its subsidiaries or its affiliates.⁴² In addition, in light of the Sarbanes-Oxley requirements, the institution should consider appointing at least one director who, if not a “financial expert,” at least has some experience with financial reporting issues.

The role of the audit committee primarily involves the supervision of the internal and external audit functions of the institution. Other responsibilities might include establishing policies and procedures to ensure full and accurate disclosure of the institution’s financial condition; monitoring management and staff compliance with board policies, laws, and regulations; measuring the effectiveness of the institution’s compliance management program; an annual review of the external auditor’s independence; management consultation; seeking an opinion on an accounting issue; and oversight of the quarterly regulatory process. The audit committee should report any of its findings periodically to the board of directors.⁴³

In fulfilling its role with regard to the external auditing function, the audit committee is responsible for the consideration of and decision on the most appropriate external auditing program for the institution. The audit committee should undertake this effort at least annually. The committee should first identify the various risk areas of the institution. It should then determine the extent of the external auditing program that is needed to evaluate these risk areas, taking into consideration the size of the institution, the nature, scope and complexity of its operations, and the potential benefits of the external auditing programs under consideration. In addition, the audit committee should consider whether a specific external auditing program is

³⁹ FDIC FIL 96-99, *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* (Oct. 25, 1999); FDIC FIL 17-2003 Attachment I, *Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with Less than \$500 Million in Total Assets That Are Not Public Companies* (March 5, 2003).

⁴⁰ Annual Independent Audits and Reporting Requirements, 12 CFR § 363.

⁴¹ Annual Independent Audits and Reporting Requirements, 12 CFR § 363; FDIC FIL 17-2003 Attachment I, *Applicability of Selected Provisions of the Sarbanes-Oxley Act of 2002 to FDIC-Supervised Banks with Less than \$500 Million in Total Assets That Are Not Public Companies* (March 5, 2003); FDIC FIL 96-99, *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* (Oct. 25, 1999).

⁴² FDIC FIL 96-99, *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* (Oct. 25, 1999).

⁴³ OTS, *The Directors’ Guide to Responsibilities* (Oct. 17, 2006); FDIC FIL 96-99, *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* (Oct. 25, 1999); OTS Examination Handbook, Section 310.5: *Management, Audit Committee*.

warranted for a particular year or period of years because of high risk areas or areas of special concern.⁴⁴

Once the decision on the type of external auditing program has been made, the audit committee should communicate and come to an agreement on the objectives and scope of the external audit program with the external auditor. The decision on the external audit program and the reasons for its design and scope should be recorded in the minutes of the audit committee or board of directors.⁴⁵

The first step in establishing an audit committee is the adoption of a charter for the committee. Appendix D is a sample charter for an audit committee of a mutual institution. The sample is necessarily general in nature; not all provisions included will be appropriate for every institution; and all provisions appropriate or necessary for a particular institution may not be included. The document is meant to provide a drafting starting point in order to achieve a charter that addresses a particular institution's needs.

B. Nominating Committee

In November of 2003, the SEC adopted rules regarding nominating procedure disclosures.⁴⁶ Under the rules, each publicly traded company must disclose to its stockholders whether or not it has a standing nominating committee (or a committee having similar functions) and, if not, a statement of the reasons why not and the names of the directors who participate in the consideration of director nominees. The company must also disclose whether the nominating committee has a charter, and if so whether it can be found on the company's website. The company must also make disclosures as to the independence of the members of the nominating committee. Disclosures must be made as to whether and how stockholders may nominate persons to the board of directors, along with the qualifications that the nominating committee requires and considers for nominees.

While these requirements do not apply to mutual institutions, board nomination policies and procedures are of particular importance to mutual institutions concerned about the activities of professional depositors. It is a common technique for these depositors to bring about significant changes through the election of new leadership to the board of directors. The ability, or lack thereof, of these activist depositors to nominate themselves or others to the board is central to the success, or failure, of their efforts.

Under the regulations of the OTS, the bylaws of federally chartered mutual institutions must provide that nominations to the board of directors may be made at the annual meeting by any member and that such nominations will be submitted to a vote. However, the institution has the option to require that member nominations be submitted to the secretary of the institution at least 10 days prior to the annual meeting. Note that if the mutual institution elects to adopt this prior notification requirement, the institution is then required to have a nominating committee.

⁴⁴ FDIC FIL 96-99, *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* (Oct. 25, 1999).

⁴⁵ *Id.*

⁴⁶ Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, 17 C.F.R. Parts 228, 229, 240 et al.

The nominating committee is required to submit nominations to the secretary at least 15 days prior to the annual meeting.⁴⁷

Although the OTS regulations seem to require that all members be given the right to nominate persons for director, this is not necessarily always true. The OTS issued a statement and proposed a rulemaking that permitted mutuals to adopt an optional bylaw provision that would restrict the nomination rights of a person convicted of a crime involving dishonesty or breach of trust, or subject to a cease and desist order by a banking agency for conduct involving dishonesty or breach of trust.⁴⁸

Most states do not address director nomination in their provisions on mutual corporate governance. Thus, it is left to the mutual institution to set its own nomination rules and procedures in its bylaws, and to establish a nominating committee if it so chooses. There is no required standard communication with members regarding the process for nomination of directors.

However, establishment of a nominating committee and communication with members regarding nomination procedures, in line with SEC standards, would provide evidence of best practice corporate governance adoption and support a characterization that the mutual institution is well managed. In addition, while nomination of persons to the board of directors may be a threat to the well being of the institution if those persons are not qualified or appropriate choices for the institution, the board also has a fiduciary duty to ensure that qualified and worthy candidates for board positions are presented to depositors. The establishment of nominee qualifications, nomination procedures and a nominating committee can clarify in advance the appropriate response to depositor attempts to nominate persons to the board of directors. By following the structure set in place ahead of time, the institution ensures that unqualified nominations are not permitted, while allowing a clear process for the nomination of qualified individuals.

There are choices for creating policies and procedures for nomination and the operation of a nominating committee. The institution may choose to permit all members to nominate persons for election to the board. Alternatively, the institution may choose to place restrictions on member nominations, for example, by minimum depositor interest in the institution. The institution should also consider restricting nomination by persons convicted of a crime involving dishonesty or breach of trust, or subject to a cease and desist order by a banking agency for conduct involving dishonesty or breach of trust, as proposed by the OTS.

In addition, the institution should establish a clear process for nomination, such as submission of the nomination to the nominating committee by a certain number of days prior to the annual meeting. And finally, the nominating committee should set clear director qualifications, which must be met by any proposed nominee in order for such nomination to be presented for election.

⁴⁷ 12 C.F.R. § 544.5(b)(13).

⁴⁸ OTS Order No. 2005-13, *Approval of Application to Amend Bylaws* (March 17, 2005); Notice of Proposed Rulemaking, "Optional Charter Provisions in Mutual Holding Company Structures," 72 Fed. Reg. 35205 (June 27, 2007).

The first step in establishing a nominating committee is the adoption of a charter for the committee. Appendix E is a sample nominating committee charter for a mutual institution. Again, the document is necessarily general in nature; not all provisions included will be appropriate for every institution; and all provisions appropriate or necessary for a particular institution may not be included. The document is meant to provide a starting point from which the institution can tailor a charter to its particular needs.

Director Qualifications and Selection. The nominating committee is responsible for the establishment of the qualifications considered when selecting nominees for the board of directors. This responsibility is extremely important, given the extent to which the quality of the board of directors impacts the overall success of an institution. Director qualifications may be used not only to ensure that high quality candidates are nominated to the board, but also, conversely, can help to ensure that undesirable individuals are not eligible for nomination.

In establishing director qualifications, the nominating committee must first ensure that it complies with any requirements of its chartering authority. OTS regulations located at 12 C.F.R. § 563.33 require the board to be composed of a majority of directors who are not salaried officers or employees of the institution or any subsidiary thereof. In addition, no more than two directors may be members of the same immediate family and no more than one director may be an attorney with a particular law firm. State-chartered mutual institutions may also be subject to statutory requirements regarding the qualifications of directors. For example, Massachusetts requires that a majority of the trustees be citizens of the commonwealth of Massachusetts and that all trustees be depositors of the savings bank; Indiana requires that all directors be at least 18 years old.⁴⁹

Although the OTS requirements for outside directors are not applicable to state chartered mutuals, the motivation behind them is relevant to all mutual institutions. The OTS requirements are intended to produce a board of directors that is composed of both inside and outside directors, such that the inside directors are able to “provide internal perspectives for other board members,” while the outside directors “provide unbiased and impartial perspectives on issues brought to the board.”⁵⁰ As such, the nominating committee should be conscious of maintaining a balance of inside and outside directors when making nominations.

Where state-imposed director qualifications do not apply to a mutual institution, it may nonetheless be useful to incorporate such restrictions into the nominating committee’s director qualifications. A requirement that directors be depositors of the institution can create a stronger tie between the directors and the institution. State citizenship or community residency requirements may operate to support a mutual institution’s community oriented approach to banking. Age requirements imposing minimum limits can serve to encourage the selection of directors with a certain level of experience, while age restrictions setting a required retirement age may be intended to encourage turnover on the board. The decision to adopt these kinds of qualifications rests with the nominating committee and ultimately with the board of directors, which must make the decision, as with all decisions, that is best suited to the particular needs of the institution.

⁴⁹ MASS. GEN. LAWS ch. 168 § 10; IND. CODE § 28-13-9-2.

⁵⁰ OTS Examination Handbook, Section 310.19: *Management, Composition of the Board of Directors.*

In addition to such specific restrictions and requirements, the nominating committee must establish those other qualities that the institution desires its directors to possess. Among the most important are the skills and experience of the directors. In particular, directors should possess sound business judgment and experience that facilitates an understanding of banking and banking problems. The candidate should also be familiar with the community and trade area that the institution serves, as well as with general economic conditions. A working knowledge of the duties and responsibilities of the office of director is also desirable.⁵¹

The nominating committee must also consider certain personal qualities of the proposed nominee. According to the FDIC, “[t]he one fundamental and essential attribute, which all bank directors must possess without exception, is personal integrity.” Given the importance of the fiduciary responsibilities of loyalty and care that a director undertakes, to both the institution and its depositors, a director must possess candor, personal honesty and integrity. The director must have the ability to recognize and avoid potential conflicts of interest, or even the appearance of such. A director should possess the ability to act with objectivity and independence.⁵²

In addition to individual evaluation of potential nominees, the nominating committee could impose a blanket prohibition on the nomination of any person convicted of a crime involving dishonesty or a breach of trust, or who has been subject to a cease and desist order by a banking regulator for conduct involving dishonesty or a breach of trust as noted by the OTS proposed rule.⁵³ According to the OTS, such a policy is appropriate, in that “trust is fundamental to the banking industry and the lack of trust in the managers of institutions will adversely affect their businesses.”⁵⁴ At least one state clearly agrees with this approach; California prohibits any person convicted of a criminal offense involving dishonesty or a breach of trust from serving as a director of a mutual savings institution.⁵⁵ This type of disqualification is clearly designed to prevent undesirable candidates from being eligible for nomination to the board.

V. Policies and Procedures

As discussed in Section III., above, the charter and bylaws of an institution generally establish the governance framework within which the institution will operate, addressing basics of governance such as number of directors, procedures for election of directors, policies for meetings of members, roles of officers and methods of election of officers, and so on. Although well-structured bylaws are essential to effective corporate governance, in today’s corporate atmosphere, they are not sufficient. In response to new standards in governance, and in some cases, legal requirements, many institutions are choosing to set out additional governance structures in written policies and procedures.

These types of governance polices operate as an adjunct to the bylaws, complementing and providing further guidance to the framework established by the bylaws. By setting out governance policies and procedures in writing, the board of directors not only defines its

⁵¹ FDIC Risk Management Manual of Examination Policies, Part II Section 4.1: *Management*.

⁵² *Id.*

⁵³ “Optional Charter Provisions in Mutual Holding Company Structures,” 72 *Fed. Reg.* 35205 (June 27, 2007).

⁵⁴ OTS Order No. 2005-13, *Approval of Application to Amend Bylaws* (March 17, 2005) available at <http://www.ots.treas.gov/docs/6/65013.pdf>.

⁵⁵ CAL. FIN. CODE § 6151.

expectations for itself, but is able to clearly convey its expectations regarding specific issues to its officers, employees, members and, even its customers. Written policies are a means to commit to sound governance and communicate that commitment both inside the institution and to the community and depositors it serves.

Further, policies and procedures provide concrete guidance regarding governance to an institution's leadership without the inflexibility of bylaws. For example, amendments to the bylaws of a federally chartered mutual institution must be approved by majority vote of either the members of the institution or the board of directors.⁵⁶ Provisions for amendments to the bylaws of state chartered mutual institutions vary from state to state. Some states grant members the right to amend the bylaws; others leave it up to the mutual savings association to determine in its bylaws. Others, such as Alabama restrict the right of the board of directors to amend the bylaws.⁵⁷ Amendments to the policies and procedures of a mutual institution are not generally subject to such restrictions. For example, the OTS requires only that all major policies be approved by the board of directors.⁵⁸

There are various types of policies and procedures that an institution may choose to adopt. The three that have received heightened attention are the following.

A. Code of Ethics

Mutual institutions are not required by law to have a code of ethics. Section 406 of Sarbanes-Oxley requires institutions to disclose whether they have adopted a code of ethics for senior officers, and if not, why not. Disclosure of any changes or waivers of the code of ethics is also required. Notwithstanding the lack of formal requirements, there are many good reasons for a mutual institution to adopt a written code of ethics. First, the FDIC, the OTS, and the FRB expressly *encourage* mutual institutions to do so.⁵⁹ In addition there are many practical benefits to institutions that choose to adopt a written code of ethics. As with all written policies, a written code of conduct effectively establishes the board's expectations for itself, and communicates those expectations throughout the institution. It sets the tone for a firm commitment to honest, ethical conduct, accountability, and compliance with the law.

In developing a code of ethics, a mutual institution would be well advised to review FDIC guidance on the topic contained in Financial Institution Letter 105-2005, *Corporate Codes of Conduct: Guidance on Implementing an Effective Ethics Program*.⁶⁰ According to the FDIC, issues that should be addressed in an institution's ethics policy include: safeguarding confidential information; ensuring the integrity of records; providing strong internal controls over assets; providing candor in dealing with auditors, examiners and legal counsel; avoiding self-dealings and acceptance of gifts or favors; observing applicable laws; implementing appropriate

⁵⁶ 12 C.F.R. § 544.5.

⁵⁷ Further detail and statutory citations are available in [Appendix B](#) to this Article.

⁵⁸ OTS Examination Handbook, Section 310.8: *Management, Policies and Procedures*.

⁵⁹ FDIC FIL 17-2003, *Corporate Governance, Audits, and Reporting Requirements* (March 5, 2003); FRB SR 03-8, *Statement on Application of Recent Corporate Governance Initiatives to Non-Public Banking Organizations* (May 5, 2003).

⁶⁰ FDIC FIL 105-2005, *Corporate Codes of Conduct: Guidance on Implementing an Effective Ethics Program* (Oct. 21, 2005).

background checks; involving internal auditor in monitoring the policy; providing a mechanism to report questionable activity; outlining penalties for a breach of the policy; providing periodic training and acknowledgment of the policy; and periodically updating the policy. The complete FDIC issuance is attached as Appendix F.

Additionally, mutual institutions should also consider FDIC guidance issued in 1987, “*Guidelines for Compliance with the Federal Bank Bribery Law*.”⁶¹ This issuance encourages all insured institutions to adopt internal codes of conduct, or amend their current code of conduct, so that it includes an explanation of the general provisions of the bank bribery law, and prohibits certain actions by bank officials, primarily self dealing and acceptance of gifts or favors. Appendix G is a sample Code of Ethics to be used as a drafting starting point.

B. Conflicts of Interest

Conflicts of interest are similar, yet different from the code of ethics and have received increased attention as an issue unto themselves, particularly as a result of the requirements of Section 402 of Sarbanes-Oxley, which addresses extensions of credit by public companies to their directors and officers. As with the code of ethics provisions of Sarbanes-Oxley, mutual institutions are not subject to Section 402. However, institutions subject to regulation by the FRB, OTS or FDIC are required to comply with the requirements of Regulation O, dealing with loans to directors, officers, and principal shareholders of a financial institution.⁶²

It is important to remember that avoiding conflicts of interest is a foundational responsibility of a director or officer of a mutual institution. As discussed above in Section I. B., directors and officers owe a fiduciary duty of loyalty to the institution. This duty is equivalent to the duty to avoid conflicts of interest; that is, the director or officer has a duty to carry out all aspects of his or her responsibilities in keeping with the best interests of the institution. The officer or director may never advance his or her personal interests, or the interests of family or associates, at the expense of the institution.

Fulfilling the duty to avoid conflicts protects management and the institution from liability and adverse regulatory action. Additionally, the avoidance of conflicts, or even the appearance of conflicts protects the reputation of the institution. Establishing a written policy on conflicts of interest brings with it all of the general advantages of having written policies: clear communication of expectations within and without the institution. Additionally, adoption of a conflicts of interest policy is itself an aspect of fulfilling the duty to avoid conflicts, and any appearance of conflicts.⁶³

⁶¹ Guidelines for Compliance with the Federal Bank Bribery Law, 52 Fed. Reg. 43,941 (Nov. 17, 1987) available at <http://www.fdic.gov/regulations/laws/rules/5000-2300.html#5000guidelinesfc>. See also FDIC FIL 17-2003, *Corporate Governance, Audits, and Reporting Requirements* (March 5, 2003).

⁶² 12 C.F.R. §§ 215 and 563.43; FDIC FIL 17-2003, *Corporate Governance, Audits, and Reporting Requirements* (March 5, 2003). The FRB’s Compliance Guide for Small Entities, Regulation O, provides an overview of the requirements of the regulation and is available at <http://www.federreserve.gov/regulations/cg/regocg.htm>.

⁶³ For example, when conducting an examination, OTS examiners are directed specifically to review the institution’s conflicts policy, and management’s compliance therewith. OTS Examination Handbook, Section 330.11: *Management Assessment, Avoidance of Conflicts of Interest*.

A mutual institution's written policy on conflicts of interest should identify areas where such conflicts could arise. These include: transactions with affiliates; transactions with insiders, including directors, officers, employees, shareholders and anyone with influence over the policies and procedures or actions of the institution; loans to insiders, as mentioned above; and usurpation of corporate opportunities. The policy should identify controls that the association maintains to avoid conflicts and the procedures for dealing with policy violations. The policy should also identify business activities in which the members of management are active and business activities that the association is permitted to conduct by law.⁶⁴

The main function of the policy is to establish a general plan and a process for dealing with actual and potential conflicts of interest. The plan should ensure that management and the institution will comply with applicable law whenever a conflict or potential conflict arises. In particular, the plan should reference the requirements of Sections 23A and 23B of the Federal Reserve Act, addressing affiliated transactions, and Regulation O. In general, whenever a conflict or potential conflict of interest arises, the individual involved should make full disclosure to the board of directors, refrain from participating in any board discussion of the matter, and recuse him or herself from voting on the matter. In addition, the institution should fully document all disclosure, discussion and voting regarding any conflict or potential conflict of interest.⁶⁵

Appendix H is a sample Conflicts of Interest policy that provides a starting point for each institution to tailor the provisions to meet its particular needs and concerns.

C. Confidentiality

Confidentiality and privacy protection in connection with the personal information of financial institution customers continues to be a topic of concern to the financial industry and the general public. Congress responded to this concern through the passage of the Gramm-Leach-Bliley Act (the "GLBA") in November, 1999. Section 501 of the GLBA, "Protection of Nonpublic Personal Information," applicable to all FDIC insured institutions, aims to: (1) ensure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of such records; and (3) protect against unauthorized access to or use of such records or information that would result in substantial harm or inconvenience to any customer.

The FRB, OTS and FDIC have implemented the goals of Section 501 of the GLBA through interagency guidelines.⁶⁶ The primary standard is the implementation of a comprehensive written customer information protection program, the objectives of which are the

⁶⁴ See OTS Examination Handbook, Section 330.11: *Management Assessment, Avoidance of Conflicts of Interest*; FDIC Risk Management Manual of Examination Policies, Part II Section 4.1: *Management: Avoiding Self-Serving Practices and Conflicts of Interest*.

⁶⁵ See OTS Examination Handbook, Section 310.20: *Management, Conflicts of Interest*; OTS, *The Directors' Guide to Responsibilities* (Oct. 17, 2006). Additionally, note that "Guidelines for Compliance with the Federal Bank Bribery Law" also contains requirements regarding conflicts of interest. See Guidelines for Compliance with the Federal Bank Bribery Law.

⁶⁶ The guidelines are published in the regulations of each agency. For the FRB, they are at 12 CFR Parts 208, 211, 225 and 263; for FDIC, 12 CFR Part 364; for OTS, 12 CFR Parts 568 and 570. Attached as Appendix I are the guidelines as promulgated by the FDIC.

same as those of Section 501 of the GLBA. The board of directors or a committee of the board is responsible for the development, implementation and maintenance of the program, which responsibilities include assigning specific responsibility to officers for implementation and maintenance. The board of directors should review officers' reports on the program, describing overall status and compliance, at least annually.

In this case, adoption of a written policy is mandated for all mutual institutions regulated by the FRB, OTS or FDIC. However, compliance with the requirements of the GLBA is not the only reason to adopt a written policy addressing confidentiality of customer information. In order to effectively protect customer information, and thereby prevent financial losses to its customers and itself, and protect the reputation of the institution with its customers and the general public, a written confidentiality policy is essential. The day-to-day business of a financial institution requires pervasive use of sensitive customer information at virtually all levels of the institution. In order to effectively implement a confidentiality policy, the board must effectively communicate the goals and procedures of a clear program throughout the institution.

Because a comprehensive written program is required under the GLBA, specific guidance regarding the structure and content of confidentiality policies is available. First, the policy should establish that the program must include administrative, technical and physical safeguards for customer information, as appropriate to the size and complexity of the institution, and the nature and scope of its activities. The program must provide for risk assessment, followed by management and control of the risks identified. In addition, the policy must provide for a response program to address incidents of unauthorized access to customer information. The program should provide for identification of the information or information systems accessed or misused, possible notification of the institution's primary regulator, compliance with Suspicious Activity Report requirements, where applicable, containment and control to prevent further access or misuse, and possible customer notification.⁶⁷ A number of states have enacted legislation on this issue that may add more specific notification requirements among others. A chart of recent enactments is attached as [Appendix K](#).

Additionally [Appendix J](#) is a sample confidentiality policy again designed to provide a starting point for customization to reflect the particulars of a given institution. It is important to resist adopting generic policies as they will not reflect the actual policies and procedures put into practice.

VI. Conclusion

There are benefits to corporate governance procedures that reflect the best practices of all industries - smoother operation of the institution and its board, clear guidance to directors and potential directors, and comfort in a well-earned reputation for integrity and ethical conduct. There are ancillary benefits as well – control and predictability in the selection of directors and judicial recognition of decisions made in a best practices environment. It also happens to comply with regulator expectations and statutory guidance. All good reasons for boards of directors and management to invest the time and investigation into those practices and procedures that will allow their institutions to continue to grow and serve their communities.

⁶⁷ Appendix I, "Supplement A to Appendix B to Part 364 Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice.



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