



Counsel for  
BOARD AND EXECUTIVES

# Acredula®



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## Bricker & Eckler LLP

100 South Third Street  
Columbus, Ohio 43215-4291

Phone 614 . 227 . 2300  
Fax 614 . 227 . 2390  
info@bricker.com  
www.bricker.com

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**A**credula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives. Acredula is available to clients and friends of the firm. It is not to be construed as legal advice or opinion.

## Relying on Common Sense, Not Complex Rules to Identify Fraud

The basic principle of the Sarbanes-Oxley Act of 2002 (SOX) is that the first and best line of defense against corporate mismanagement and fraud is independent oversight of management by independent directors with the assistance of independent advisers, including independent audits of financial statements by independent auditors, and accountability of executives for the information provided. However, SOX is only one of a complex maze of federal and state laws dealing with corporate governance and responsibility. This maze of laws ranges from state statutory and common laws to federal tax and securities laws to laws governing the conduct of lawyers and accountants. One of the most important of these laws are the rules regarding regulated industries – such as insurance and banking regulations for management and the safety and soundness of insurers, banks, and their holding companies.

This issue of *Acredula* examines corporate governance trends and recent observations from Robert H. Moone, David Lehman and me, including recent activities by regulators of the banking and insurance industry.

Bob Moone is Chairman, CEO and President of State Auto Financial Corporation and State Automobile Mutual Insurance Company. Bob shares some of his observations regarding recent activities of the Securities Exchange Commission and Nasdaq.

David Lehman is President of Mennonite Mutual. David has had recent experience with the

Ohio Department of Insurance in its triennial examination of Mennonite Mutual.



### EDITOR'S NOTE

**John P. Beavers**  
Partner,  
Bricker & Eckler LLP

The article also includes recent trends from a Buck Consultants survey.

Without being critical of recent activity by regulators, the three of us conclude in the article that independent directors are the first and best line of defense against dishonest and

unethical behavior, especially when:

- Aware of their fiduciary duties of care and of loyalty
- Educated as to their company's business and products
- Empowered with appropriate authority
- Authorized, when deemed appropriate in their discretion, to engage independent legal counsel or other advisors.

This line of defense is even better when coupled with the combination of an independent external auditor and a competent internal auditor that report to those independent directors, with each freely communicating with the other.

Common sense can better identify dishonest or unethical behavior better than complex rules. Independent directors, the external auditor and any internal auditor are much closer and more knowledgeable to oversee an organization's activities than any regulator. These are the best stewards of our public companies.

# Corporate Governance Observations and Recent Trends

By

**Robert H. Moore**

Chairman, CEO and President  
State Auto Financial  
Corporation

**David Lehman**

President  
Mennonite Mutual

**John P. Beavers**

Partner  
Bricker & Eckler LLP

Enron, Tyco, Imclone, Dynergy, Adelphia and WorldCom have shaken investor confidence in corporate America. The focus of Congress, the SEC, the stock exchanges, institutional investors, rating agencies, large creditors, and even unions is independent oversight of management. All view that the best line of defense against corruption is a combination of independent directors with an independent external auditor and a competent internal auditor that report to those independent directors, with each freely communicating with the other. Regulators of regulated industries such as banking and insurance now have the same focus. The purpose of this article is to share (i) observations of what financial services industry regulators are doing and (ii) trends from recent surveys on board governance in a post-SOX (Sarbanes-Oxley) environment.

## Observations of what regulators are doing

From the view point of our practice of law, financial services industry regulators are increasingly treating governance as the “foundation of the safe and sound operation” of a financial service company. Although mutual insurance companies are not subject to SOX or the SEC, NYSE, Nasdaq or Public Company Accounting Oversight Board (PCAOB) rules thereunder, insurance regulators are likely to recommend that all companies, not just those subject to SOX, adopt some of the corporate governance practices resulting from SOX to the extent feasible given each company’s size, complexity, and risk profile, just as banking regulators have.<sup>1</sup> Below are some observations of the corporate governance practices that we see as the current focus of regulators:

**1. Board composition.** In addition to the independence required by SOX for audit committee members and by NYSE and Nasdaq for a majority of board members as well as for compensation and nominating/governance committee members, regulators are increasingly taking the position that sound corporate practice requires boards to review the particular knowledge and experience that each independent director candidate brings to the company as a whole. We have heard regulators say that boards need to have the knowl-

edge and experience to understand not only the company’s business, but, more particularly for the financial services industry, the company’s products. In addition, regulators are increasingly inquiring whether a board has sufficient independent directors with financial knowledge and experience to serve as an audit committee; with compensation knowledge and experience to serve as a compensation committee; and governance knowledge and experience to serve as a nominating/governance committee.

**2. Independence among boards of affiliates.**

In addition to the SOX, NYSE and Nasdaq definitions of independence from management, regulators are increasingly taking the position that sound corporate governance requires independence of at least some of the independent directors from affiliated companies. For example, regulators believe sound corporate practice requires that the boards of a parent and of a subsidiary consist of independent directors who are not on the board of the other. When two or more entities having common directors on their boards are parties to, or otherwise have interests in, the same transaction, regulators are increasingly examining minutes of board proceedings to determine whether these transactions were considered separately by the non-common directors.

**3. Independent oversight of the amount and incentives of compensation.**

Regulators are increasingly taking the position that sound corporate practice requires independent oversight of the amount and incentives of executive compensation. Regulators appear keenly aware that the courts are finding that abusive compensation practices with misplaced incentives were the major contributing factors to fraud at Enron and WorldCom. We can assume regulators are also keenly aware of the SEC’s public questioning of the oversight of the amount and incentives of the compensation to which the boards of the NYSE and General Electric either agreed or acquiesced.

**4. Internal controls and the internal audit function.**

More and more, regulators are taking the position that all companies need to have internal controls comparable to those required of public reporting companies and, if the company is of a sufficient size or complexity, all companies need to have an internal audit

Financial services industry regulators are increasingly treating governance as the “foundation of the safe and sound operation” of a financial service company.

function. Regulators are increasingly examining whether these internal controls are being periodically evaluated and tested under the oversight of the company's board or audit committee.

5. **Oversight of the audit process.** Regulators are increasingly taking the position that sound corporate practice requires oversight of the audit process of any company, whether or not subject to SOX, by the independent directors of the company's governing board or an audit committee of independent directors of the board. Regulators are examining the extent that the board or audit committee have, and actually exercise, authority for hiring, firing, and determining the compensation and scope of both audit and non-audit work of the external auditor as well as for their authority for overseeing that internal controls are effected. Regulators are encouraging boards of companies not otherwise required to do so to establish an audit committee consisting entirely of independent directors and are examining engagement letters with external auditors to determine whether the auditor reports to the board or audit committee rather than to management.
6. **Elimination of non-audit services by the external auditor.** To provide confidence in the financial statements of any regulated company, regulators are taking the position that sound corporate practice requires that all companies, whether or not subject to SOX, are to have an audit report by an external auditor independent of any interest in providing services to the organization other than audit and tax services.
7. **Continuing board education.** Because financial products and services being offered by the financial services industry are increasingly more complex, regulators are taking the position that sound corporate practice requires companies to educate the board on these products. In addition, regulators believe that sound corporate practice requires companies to periodically refresh boards on:
  - Basic fiduciary duties;
  - Advanced fiduciary duties, such as during a merger or acquisition;
  - The functions of the board and the functions of management;
  - The board's role in regulatory relationships;
  - Applicability of various consumer laws;
  - Applicability of various securities laws;
  - Prohibition or policies regarding insider loans;
  - Overview of related party transactions; and

- The board's and auditor's role in compliance.

8. **Accounting issues.** Regulators are strongly encouraging companies to make all material correcting adjustments identified by external auditors regardless of the type of external auditing program the company has implemented and to disclose material off-balance sheet transactions to ensure that examiners and other users of the financial statements are aware of them and can include them in their evaluation of the company's condition and risk profile.
9. **Conflicts of interest.** More and more, regulators are taking the position that sound corporate practice requires knowledge by the board and management of potential conflicts of interest. Regulators are examining codes of conduct or policies to determine if they require a company's directors and officers to disclose all potential conflicts of interest, including those in which they have been inadvertently placed due to either business or personal relationships with customers, suppliers, business associates, or competitors of the bank. They are also examining whether such relations are, as a matter of course, being disclosed.

## Trends from recent surveys

Buck Consultants, a human resources consulting firm based in New York, released a Board of Directors Survey in June 2003. We can observe the following trends when comparing the Buck Survey with surveys conducted by Executive Compensation Advisory Services in 2002 and 2001 and by *Acredula* in 2000.

## Board Composition

### Management versus non-management members

The Buck Survey shows a continuing decrease, albeit at a lesser rate than from prior surveys, in the number of management or "inside" directors as boards add directors to meet the independence requirements for audit and the other oversight committees.

	Total number of directors	Inside directors as percent of total	Outside directors as percent of total
75th percentile	11	22%	89%
Median	9	14%	86%
25th percentile	8	11%	78%

### Average age of directors

As reported in the Buck Survey, the age of directors is not significantly different from prior surveys.

Total number of directors	
75th percentile	61
Median	59
25th percentile	56

### Types of expertise represented on boards

Although CEOs of other companies remain the principal expertise represented by board members (which was a trend through the 1990s), the Buck Survey shows a trend beginning in the 2000s to broaden the expertise present on boards.

Expertise	Criteria cited by the percentage of the surveyed companies
Active CEO from other companies	82%
Active senior executive (other than CEO) from other companies	75%
Academician	46%
Consultant	42%
Venture capitalist	34%
Retired company executive	33%
Independent attorney	31%
Major shareholder	29%
Investment technology executive	25%
Investment banker	19%
Former government official	17%
Commercial banker	13%
Physician	12%

Academicians, consultants and investment technology executives have increased, while retired company executives, investment bankers and commercial bankers have decreased when compared to prior surveys.

### Financial reporting experience

The percent of board members with financial reporting experience is increasing and will likely continue to do so as boards find members to meet the requirements for their audit and compensation committees.

Percent of board members with financial reporting experience	
75th percentile	29%
Median	17%
25th percentile	11%

### Board members whose employers do business with the company

The percent of board members whose employers (or former employers) do business with the company is as follows:

Percent of board members whose employers (or former employers) do business with the company	
75th percentile	33%
Median	22%
25th percentile	14%

The percentage of board members whose employers do business with the company is decreasing, albeit slowly.

### Staggered board terms

Substantially all boards have staggered terms despite concerns of regulators and investors to the contrary.

Percent of boards with staggered terms	
Yes	94%
No	6%

### Board proceedings

#### Number of board meetings

The Buck Survey shows a continuing increase in the number of board meetings from prior surveys.

	Total Number of Meetings	In-Person Meetings	Telephonic meetings
75th percentile	9	100%	25%
Median	7	100%	0%
25th percentile	5	75%	0%

#### Length of board meetings

The Buck Survey shows a continuing trend toward longer board meetings when compared to prior surveys.

Length of meeting	Percent of boards
0.5 day	33%
Full day	42%
1.5 days	14%
2 days	8%
More than 2 days	2%

## Boards meeting regularly without management

Although we do not have comparable prior data, over half of the surveyed companies' boards meet regularly without management according to the Buck Survey.

Percent of boards meeting regularly without management	
Yes	55%
No	45%

## Types of board committees

The Buck Survey shows a continuing increase in audit, compensation and nominating/governance committees, and a decrease in executive committees from prior surveys.

Committee	Percent of boards
Audit	99%
Compensation	99%
Nominating/governance	47%
Executive	38%
Finance	17%
Investment	7%
Strategic planning	5%
Pension	4%
Public policy	4%
Environmental	4%

## Number of committee meetings

The Buck Survey shows a continuing increase in the number of audit, compensation and nominating/governance committee meetings, and a decrease in executive committee meetings from prior surveys.

Committee	25 <sup>th</sup> percentile	Median	75 <sup>th</sup> percentile
Audit	4	6	8
Compensation	3	4	6
Nominating/governance	1	3	4
Executive	0	1	4
Finance	2	3	4
Investment	2	4	4
Strategic planning	2	3	5
Pension	2	3	5
Public policy	2	2	3
Environmental	1	2	4

## Board evaluations

The Buck Surveys shows an increase in the number of boards evaluating themselves annually, but a vast majority of boards do no such evaluations.

Percent of boards evaluating themselves annually	
Yes	17%
No	83%

Of those boards that perform an evaluation, the following shows the type of evaluation:

Percent of boards	
Peer review only	34%
Self evaluation only	34%
Combination	31%

Of those boards that perform an evaluation, the following shows the criteria used:

Percent of boards	
Over-all contribution	83%
Business knowledge	76%
Industry awareness	76%
Committee work contributions	72%
Board participation, speaking out	72%
Provides valuable input	69%
Attendance	66%
Teamwork	62%
Meeting preparation	59%
Long-range planning contributions	45%
Available when needed	38%

## Recent and anticipated changes

### Recent changes as a result of SOX and increased focus on governance

Although we do not have comparable prior data, the Buck Survey shows the following changes have been made during the past years by boards of the surveyed companies:

Change	Percent of boards
Realigned committee membership	46%
Hired independent consultant	43%
Sought new board member with certain expertise	42%
Increased number of committee meetings	39%
Committees held meetings without management	33%
Provided director education	18%
Increased number of full board meetings	8%

### Anticipated changes as a result of SOX and governance

Although again we do not have comparable prior data, the Buck Survey shows the following changes are anticipated during the ensuing year by boards of surveyed companies:

Change	Percent of boards
Seek new board member with certain expertise	24%
Provide director education	17%
Realign committee membership	16%
Hold committee meetings without management	14%
Increase number of committee meetings	11%
Hire independent consultant	11%
Increased number of full board meetings	9%

## Conclusion

Neither Congress nor regulators can mandate honesty and ethics with legislation and rules. As said by Alan Greenspan, “rules cannot substitute for character.”<sup>2</sup> What we need is business leaders with high ethical standards.

Independent directors of a board of a public company are the first and best line of defense against dishonest and unethical behavior. We should be focusing on how we attract and retain those types of directors as stewards of our publicly-held companies.

<sup>1</sup> March 2002 speech at the Stern School of Business, New York University.

### Counsel for BOARDS AND EXECUTIVES

John P. Beavers, Chair  
614.227.2361  
jbeavers@bricker.com

Jerry O. Allen  
614.227.8834  
jallen@bricker.com

Alex M. Brown  
614.227.2344  
abrown@bricker.com

Thomas R. Brownlee, Jr.  
614.227.2301  
tbrownlee@bricker.com

John W. Cook, III  
614.227.2383  
jcook@bricker.com

Michael E. Flowers  
614.227.2340  
mflowers@bricker.com

James F. Flynn  
614.227.8855  
jflynn@bricker.com

Michael K. Gire  
614.227.2318  
mgire@bricker.com

Steven R. Kerber  
614.227.2356  
skerber@bricker.com

Quintin F. Lindsmith  
614.227.8802  
qlindsmith@bricker.com

Gordon F. Litt  
614.227.2305  
glitt@bricker.com

Christine M. Poth  
614.227.2395  
cpoth@bricker.com

Richard D. Rogovin  
614.227.2352  
rrogovin@bricker.com

James A. Rutledge  
614.227.8830  
jrutledge@bricker.com

David C. Spialter  
614.227.2342  
dspialter@bricker.com

Michael F. Sullivan  
614.227.2337  
msullivan@bricker.com

Betsy A. Swift  
614.227.8850  
bswift@bricker.com

Kurtis A. Tunnell  
614.227.8837  
ktunnell@bricker.com

Faith M. Williams  
614.227.2374  
fwilliams@bricker.com

Randolph C. Wiseman  
614.227.2310  
rwiseman@bricker.com