Counsel for
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Acredula 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.

When May Boards Prudently Delegate?

EDITOR'S NOTE

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This is a great time to be a board member of any organization because governance is being re-thought and fine-tuned. Our first article deals with the impact of this re-thinking of governance on all entities, not just publicly held companies, but also privately held companies as well as tax-exempt organizations.

Our second article is by Win McCausland who has spent 30 years managing investment risks for insurance and financial institutions. One of the areas of governance being delegated to boards is oversight of the investment performance and risk of their companies' investments. A recent ruling by a Federal District Court in Houston held that the Department of Labor as well as former Enron employees stated a claim against Enron directors for failure to oversee and monitor the risk of Enron's investments. Win discusses five questions that directors should be asking.

The basic tenet of all of the new legislation, rules and decisions on governance is that the first and best line of defense against corporate mismanagement is independent oversight by independent directors.

Boards of all organizations, not just publicly held companies, direct management rather than manage the organization. To do so, boards must delegate. The issue is "when may boards prudently delegate?"

Because a board directs rather than manages and because management manages under that direction, a board must determine reliability and competence of management for each matter that the board delegates to them. The best way to determine reliability and competence is to ask questions. Accordingly, the purpose of the questions must be to test management's reliability and competence.

The same questions should be asked separately of different persons, trying to include, where appropriate, someone independent of management. Possible persons independent of management include the person serving the internal auditor function, representatives of the external auditor, outside legal counsel, and outside experts with experience in the matters under consideration.

The consistency of the different answers should be compared. The answers among different constituencies will unlikely be the same. For example, management is more likely to view certain business issues more positively than the external auditor or chief legal officer. On the other hand, the external auditor and chief legal officer are more likely to view risks of liability as more material than management.

The skill is to learn when to stop asking questions. Nothing is more bothersome to management than irrelevant, unnecessary questions. As a general rule, directors should stop asking questions and accept the answers when those answers are consistent. On the other hand, directors should delve deeper when the answers to the questions are inconsistent.

Directors and management should expect that there will be some tension between them during this process. Management needs to understand that directors must ask questions to determine whether management is reliable and competent for the matters delegated to them. The board should understand that management will fear "being micro-managed" or "not being trusted."

A way to relieve this tension is for the board to have regular executive sessions separately with different members of management so that it becomes part of the routine operation of the board. A board should consider meeting regularly with the CEO, CFO, chief legal officer, internal auditor, and representatives of the external auditor.

Principles of Sarbanes-Oxley Impact All Organizations

By
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Only three provisions of the Sarbanes-Oxley Act of 2002 (SOX) apply to persons other than public reporting companies.[1] These three provisions, generally known as the "Arthur Andersen provisions," make it illegal to:

- Destroy or falsify any record with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any bankrupt case;[2]
- Knowingly, with the intent to retaliate, interfere with the lawful employment or livelihood of any person providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense;[3] or
- Obstruct, influence, or impede any official proceeding.[4]

The remainder of SOX, including its basic principles, literally applies only to public reporting companies. The basic principle of 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 with 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. Although 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, the touchstone of this complex maze is and will remain state laws governing corporations and other organizations. The basic and other principles of SOX can be achieved under these state laws by stakeholders of any organization, including shareholders of closely held organizations, regulators of companies in regulated industries, the Internal Revenue Service with respect to tax-exempt entities, state attorneys general with respect to non-profit corporations, and creditors of any organization. Accordingly, the impact of SOX is much greater than just public reporting companies.

Independent Oversight

One of the principles of SOX is that independent directors are to have sole authority for hiring, firing and determining the scope of work and compensation of the organization's external auditors. The NYSE and Nasdaq have expanded the authority of independent directors to include:

- Determining the compensation of the organization's CEO and four other highest-paid executives, and
- Nominating candidates to become directors and planning for management succession.

Most states' for-profit and non-profit corporation laws are consistent with this SOX principle. Those laws typically provide that, unless otherwise provided in an organization's governing documents, all of the authority of the organization, including but not limited to authority for the audit, compensation and nominating processes, shall be exercised by or under the direction of its directors. Those laws also provide that, to the extent that a director has a personal or economic interest such as an interest of an officer in any matter, any action regarding that matter must be approved by a majority of disinterested directors in order for the directors to have the protection of the business judgment rule.

Accordingly, because the same result can be achieved under most states' laws, a likely impact of SOX is that independent directors will be required to have authority over the audit, compensation and nominating processes by stakeholders in any organization, including shareholders of closely held organizations, regulators of companies in regulated industries, the Internal Revenue Service with respect to tax-exempt entities, state attorneys general with respect to non-profit corporations, and creditors of any organization.

Right of Boards and Committees to Independent Counsel and Advisers

Another principle of SOX is that an audit committee is to have authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties, the fees and expenses of which are to be funded by the organization. The NYSE and Nasdaq are expanding these rules to authorize compensation and nominating/governance committees to engage their own independent counsel and other advisers to be funded by their organizations.

Most states' for-profit and non-profit corporation laws are consistent with this SOX principle. Those laws entitle:

- A committee of an organization's board to rely upon information, opinions, reports, or statements provided by legal counsel, public accountants, or other persons as to matters that the committee reasonably believes are within the person's professional or expert competence; and

- A director who is not on a committee to rely upon that committee as to matters within its designated authority as long as the director reasonably believes the committee merits confidence.

Again, because the same result can be achieved under most states' laws, a likely impact of SOX is that stakeholders in any organization will require:

- Compensation committees to have authority for hiring, firing and determining the scope of work and compensation of their organizations' compensation consultants, and
- Nominating/governance committees to assume similar authority for their organizations' executive and director search and recruiting consultants.

These stakeholders will likely include shareholders of closely held organizations, regulators of companies in regulated industries, the Internal Revenue Service with respect to tax-exempt entities, state attorneys general with respect to non-profit corporations, and creditors of any organization.

Risk of Liability of Directors

SOX also recognizes a basic tenet of for-profit and non-profit corporation law that, although all authority of an organization is vested in the organization's board, a board does not directly exercise all of that authority, but it is exercised "under the direction" of the board. Day-to-day management of the organization and its business is left to management, and the role of a board is to "direct" management through:

- Decision making as to matters of policy, direction, strategy and governance;
- Oversight as to matters critical to the health of the organization for its various stakeholders; and
- Mentorship of the CEO and senior management.

Although Congress did not intend in enacting SOX to create additional accountability for directors, the exclusive authority granted to independent directors by SOX for oversight of the audit process and by the NYSE and Nasdaq for oversight of the compensation and nominating processes will likely result in greater risk of liability for directors under most states' laws. Most states' for-profit and non-profit corporation laws require directors in exercising any authority to do so with the care that an ordinarily prudent person in a like position would use under similar circumstances. Accordingly, a likely impact of SOX is that stakeholders in any organization will hold directors to additional duties of care because of this additional authority, resulting in a greater risk of director liability.

Executive Accountability

Under SOX, executives are to be accountable for the financial records and reporting processes of their organizations. Furious with the "I didn't know" defense of Enron's Kenneth Lay, Congress now requires through SOX that a public reporting company's CEO and CFO assume accountability for their organization's:

- Financial reports filed with the Securities and Exchange Commission (SEC), and the disclosure controls and procedures regarding the information to be so reported; and
- Financial statements filed with such reports, and the internal controls regarding the financial information contained in, substantiating, or underlying those financial statements.

However, most states' for-profit and non-profit corporation laws or judicial decisions under such laws require that all officers, including the CEO and CFO, must act with the care that an ordinarily prudent person in a like position would use under similar circumstances. Further, most states' statutory laws do not afford officers protection similar to the business judgment rule protecting directors. Accordingly, a likely impact of SOX is that executive officers will be held accountable for their organization's financial disclosures, disclosure controls, financial statements, and internal controls by stakeholders of that organization, including shareholders, regulators, the Internal Revenue Service, state attorneys general and creditors.

Independence of External Auditing Services

Another principle of SOX is audit reports on public reporting companies must be done by independent external auditors. Frustrated with Arthur Andersen's multiple roles with Enron, Congress now requires through SOX that, in order to be considered independent, the external auditor may not provide any of the following services in addition to its auditing services:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services; and
- Legal services and expert services unrelated to the audit.

Although most states' corporation laws do not require audit reports or independent auditors, many stakeholders such as creditors and regulators do require audit reports by independent auditors. Because of the lack of guidance under state law, these stakeholders are likely to use the same standards required

by SOX to determine independence of an auditor. As a result, it is likely auditors will be required by the stakeholder to refrain from providing competing or distracting services to its audit services.

Reporting and Investigatory Obligations of Lawyers

Under SOX, lawyers representing an organization have a duty to "report up" certain matters all the way to the board or independent directors of the organization. Furious with Sherron Watkins, Enron's vice president of development, for not pursuing Kenneth Lay's failure to respond to Watkins' memorandum that Enron might implode from accounting irregularities, Congress now requires through SOX that a securities lawyer for an organization must report evidence of a material violation of law or material breach of fiduciary duty to the organization's chief legal officer (or to the organization's chief legal officer and CEO). If the lawyer does not receive an appropriate response, SOX and the SEC rules thereunder require reporting of the material violation or material breach to the audit committee or another committee composed solely of non-management directors or to the entire board itself.

Under SOX, lawyers representing an organization have a duty to "report up" certain matters all the way to the board or independent directors of the organization.

One immediate impact of SOX is that the American Bar Association in August 2003 amended it Model Rules of Professional Conduct to require all lawyers (not just securities lawyers) for all organizations (not just public companies) to report a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, if either is likely to result in substantial injury to the organization, to a higher authority in the organization including, if warranted, to the organization's board. States are likely to follow the lead of the American Bar Association. However, even if the Ohio Supreme Court does not make a comparable amendment to Ohio's Rules of Professional Responsibility, courts are likely to find a reporting-up obligation on the part of Ohio lawyers under Ohio's rules regarding lawyer's competency and client loyalty comparable with that under SOX.

Protection of Directors

A final, albeit unstated, principle of SOX is that nothing in SOX is to preempt or override the protections afforded directors by state law. In order to encourage independent persons to serve as directors, state law offers a number of legal protections to persons serving as directors. These protections are not preempted or overruled by SOX and include:

- **Business Judgment Rule.** Under the business judgment rule, courts do not inquire into the wisdom of actions taken by directors in the absence of self interest, fraud, bad faith, or abuse of discretion. A court applying the business judgment rule will not second guess the merits of the decision as long as the court finds all of the following to be true:
  - The directors made a business decision (the rule does not apply to acts of directors which do not constitute business decisions);
  - The directors were disinterested (that is, they are not "on both sides of the transaction" and will not derive any personal benefit from their decision);
  - The directors exercised "due care" (as noted above, this means acting like an ordinarily prudent person would act);
  - The directors acted in good faith; and
  - The directors did not abuse their discretion.
- **Right of Reliance on Others.** Directors are permitted to rely reasonably upon information presented by officers or employees, board committees, and independent professional advisors in making their decisions. They may rely upon:
  - Officers or employees of the organization as to matters for which they are reasonably believed to be reliable and competent;
  - Legal counsel, public accountants, or other experts as to matters reasonably believed to be within their professional competence; and
  - Committees as to matters within their designated authority, and that the director reasonably believes to merit confidence.
- **Statutory Indemnification**. Most states' for-profit and non-profit corporation laws mandate indemnification of directors, officers and other employees if they are successful on the merits or otherwise in defense of any claim, action, suit or proceeding brought against them as directors, officers, or employees.
- **Contractual Indemnification**. Most states' for-profit and non-profit corporation laws permit contractual indemnification of directors, officers and other employees for any claim , action, suit or proceeding brought against them as directors, officers, or employees. However, many state courts have held that indemnification is not available for intentional misconduct and federal courts have held that indemnification is not available for securities law violations for reasons of public policy.
- **D&O Insurance**. Most states' for-profit and non-profit corporation laws permit broader coverage under D&O insurance than under statutory indemnification. If provided by the policy of insurance, courts typically will enforce D&O insurance protecting against intentional misconduct and securities law violations. An-

other value of D&O insurance is that it is available even if the corporation is insolvent and even after a change in control.

Accordingly, although SOX does not preempt or override the protections afforded to directors by state law, one of the impacts of SOX should be a review under the direction of boards of all organizations of the protections provided by their organizations' directors and officers and the extent that such protections are adequate in light of new principles of governance resulting from SOX.

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[1] Public reporting companies are those companies required to file annual reports on Form 10-K or 10-KSB with the Securities and Exchange Commission.

[2] 18 USC §1519.

[3] 18 USC §1513.

[4] 18 USC §1512.

Five Questions Directors Need to Ask About the Firm's Investment Portfolios

By
Win McCausland,
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Over the last two years, directors at many firms have been struggling with the question, "How do we restore and maintain investor confidence?" As directors with oversight of investment portfolios in financial institutions consider their ongoing responsibilities to investors, it is important that they also consider the same issue relative to the firm's customers. If the customers lose confidence in the company, sales falter and profits follow, leaving the stockholder with losses. This pattern repeats itself in every industry, but nowhere does it happen faster than with a financial institution. One need only recall the savings and loan crisis, spectacular insurance failures or the current challenges being faced by the mutual fund industry to find numerous illustrations of customers creating a "run on the bank." Here are five questions you need to keep in mind to help avoid this scenario.

1. What is the appropriate investment objective and how does the investment policy support the achievement of that objective?

The answer to this question is much more complicated than just "income," "capital preservation," "total rate of return," or some combination of the above. It is tied into competitiveness as an enterprise and considers many elements that contribute to the overall risk profile that a firm might have. It cannot be set in a vacuum and needs to consider competitive forces as well as required returns on capital. This objective, as well as the investment policies, is appropriately affected by the liabilities of the enterprise, liquidity needs, uncertainty factors, taxes, time horizon and risk tolerance, just to name a few. Acknowledging the complex character of the investment objective and understanding *why* it must be interpreted in view of the above factors is essential for understanding the ultimate product of the policy: investment results.

2. What are the biggest risks in the investment portfolio and what impact will they have on the firm's ability to meet its objectives?

It might surprise you to learn what are perceived to be the biggest risks in a portfolio from the perspective of management and how these might differ from the risks about which you are concerned. Are they concentrations to industries, particular companies, foreign currency, duration, and/or convexity? These are but a few examples of many categories of risk. Understanding these risks and managing them effectively is a key element to achieving the investment objectives. Early identification and evaluation of risk is essential for controlling and managing it. A well-constructed investment policy is where it begins. Reporting should be responsive to monitoring and identifying emerging portfolio risks.

3. Can the investment staff articulate in simple language, the rationale for a particular investment or asset exposure?

There is an old adage in the investment community: "Don't do what you don't understand." This is frequently forgotten under the pressure to do new things in pursuit of higher returns. Your investment staff should be able to articulate for you, in a simple, straightforward manner, the rationale for its decisions. Admittedly, some of the newer investment techniques, such as derivatives, are highly technical in nature. However, even these can be presented in ways that are easily understood if you keep the right questions in mind. For example, are they being used for hedging, replication or leverage? How effective are they for this purpose and what is the advantage over other instruments? Are they performing up to their expectations? If not, why not? If you don't understand it, continue to ask questions until you do. Otherwise, withhold your consent.

Early identification and evaluation of risk is essential for controlling and managing it.

4. Are the objectives in the incentive compensation plans for the investment staff aligned with overall investment objectives?

The necessity of getting alignment of incentive plans with corporate objectives is well understood. Frequently the incentive plan for the investment staff is linked to actual investment results versus investment performance benchmarks. For the portion linked to investment results, is it linked to the same objective that is contained in the statement of investment objective and policies? If not, either a re-examination of the objective or restatement of the incentive plan objective is essential. As any participant in an incentive plan will tell you, what gets measured is what gets done. Measuring and paying for the wrong objective will almost certainly yield results you don't want!

5. Are you getting truly informative reports that are responsive to these and any of your other questions?

As you review the reports on the investment portfolios that you receive from management, do they address all the issues of policy compliance? Can you tell what primary risks are present in the portfolio and how they are being addressed? Do you know how the portfolios are performing against their benchmarks and/or competitors? Do the reports identify and explain significant valuation changes? Are they consistent with GAAP reporting used for other purposes within the firm? Do they give you enough information to ask tough questions of your investment staff? You should demand informative reports that are responsive to compliance with policies and provide performance information versus benchmarks. Reporting should be dynamic enough to raise discussion of variances as well as any other questions you deem appropriate.

While this list of questions is far from comprehensive, it can provide a good basis to initiate discussions around investment related issues that come before the board or a committee responsible for the investment activity of the firm, including its pension plan. Most importantly, these questions can be used to create the framework for good governance of all the firm's investment activities.

Mr. McCausland is President of Investment Perspectives LLC, a consulting practice committed to objective evaluation of institutional investment management practices. His personal focus is on investment issues, particularly as they relate to corporate governance.

Mr. McCausland most recently served as Chief Investment Officer at Nationwide Insurance where he had responsibility for $55 billion of investments for both the life and property casualty businesses. Prior to joining Nationwide, he served as Vice President and Managing Director of MassMutual Life Insurance where he was responsible for the development of investment objectives, investment policy, board reporting and management of rating agency relationships. His recent experience with these major companies gives him significant expertise and background in understanding the unique needs and inner workings of investment portfolios and their impact upon company performance and ratings. Mr. McCausland has been active in industry affairs, serving on numerous industry-wide committees and programs.

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