



## *Sagacity – Notes from Counsel*

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**Sagacity:** The quality of being discerning, sound in judgment, and farsighted; wisdom.

### **Is Your Board Properly Managing Risk?**

First comes the fall; then comes the fallout. With accusations that boards of directors of financial institutions were asleep at the wheel while their companies engaged in increasingly risky behavior that erased millions of shareholder value and plunged the country into recession, increasing pressure is being placed on public company boards to shoulder the burden of risk oversight for the companies they serve.

A recent KPMG study reported that in a survey of 130 audit executives and board members, 60 percent believed that their corporate employees had little to no understanding of how to assess risk. That is a dangerous statistic for companies operating in a corporate governance landscape where the Securities and Exchange Commission (SEC) believes “risk oversight is a key competence of the board.” SEC Releases No. 33-9089; 34-61175, Proxy Disclosure Enhancements (Dec. 16, 2009), *available at* <http://sec.gov/rules/final/2009/33-9089.pdf> [Final Rule Release]. As one U.S. senator put it, “[B]oards will never again be able to say they did not understand the risks that the firms they oversee were taking.” Press Release, Sen. Charles Schumer, Schumer, Cantwell announce ‘Shareholder Bill of Rights To Impose Greater Accountability on Corporate America’ (May 19, 2009), *available at* [http://schumer.senate.gov/new\\_website/record.cfm?id=313468](http://schumer.senate.gov/new_website/record.cfm?id=313468). New regulations which would move corporate risk oversight from the exclusive domain of the C-suite and place it in the boardroom are moving forward on multiple fronts, from Congress to the SEC.

New SEC rules went into effect on February 28 amending Item 407 of Regulation S-K to require disclosure about the board’s role in a company’s risk oversight process and its leadership structure.<sup>1</sup> According to the SEC’s final rule release, the new disclosure rules require “companies ... to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example.” Disclosures should address, for example, “whether the individuals who supervise the day-to-day risk management responsibilities report directly to

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<sup>1</sup> The text of the new rule reads: (h) Board leadership structure and role in risk oversight. Briefly describe the leadership structure of the registrant’s board, such as whether the same person serves as both principal executive officer and chairman of the board, or whether two individuals serve in those positions, and, in the case of a registrant that is an investment company, whether the chairman of the board is an “interested person” of the registrant as defined in section 2(a)(19) of the Investment Company Act (15 U.S.C. 80a-2(a)(19)). If one person serves as both principal executive officer and chairman of the board, or if the chairman of the board of a registrant that is an investment company is an “interested person” of the registrant, disclose whether the registrant has a lead independent director and what specific role the lead independent director plays in the leadership of the board. This disclosure should indicate why the registrant has determined that its leadership structure is appropriate given the specific characteristics or circumstances of the registrant. In addition, disclose the extent of the board’s role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board’s leadership structure.

the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals.” Such disclosures should also include an explanation of the board’s leadership structure and the “reasons why the company believes that this board leadership structure is the most appropriate structure for the company. In companies in which the CEO and Chairman are the same individual, rule “amendments will require disclosure of whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company.”

An earlier proposed version of the new rules included a requirement for “information about a director’s or nominee’s “risk assessment skills.” Although the SEC removed this particular requirement based on public comments, the final rule release states, “[I]f particular skills, such as risk assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board or proponent to conclude that the person should serve as a director, this should be disclosed.”

Elsewhere in Washington, pending before Congress is the Shareholders Bill of Rights Act, which would require all public company boards to create a separate risk committee, distinct from the Audit Committee. One of the bill’s sponsors, Senator Schumer has said, “Today the oversight of how companies manage their risks is most often a responsibility of the audit committee, which has enough responsibilities already without having to focus on risk. By creating separate risk committees, boards will never again be able to say they did not understand the risks that the firms they oversee were taking.” In introducing the bill, the senator laid the blame for the financial crisis on the boardroom table: “During this recession, the leadership at some of the nation’s most renowned companies took too many risks ...” The bill itself contains a recital stating that “among the central causes of the financial and economic crises that the United States faces today has been a widespread failure of corporate governance.” Under the legislation, the committee would be comprised of independent directors, and the SEC would be charged with creating and enforcing rules governing such committees. Another bill pending before the Senate Committee on Banking, Housing and Urban Affairs would require only systemically important financial institutions to create separate risk committees.

With the increased emphasis risk oversight and with the possibility of risk committees being mandated for some or all public companies, companies are reevaluating how they handle risk at the board level, with some choosing pro-actively to create a risk committee. While having a stand-alone risk committee can serve to relieve strained audit committees, it is important that qualified, independent directors serve on the risk committee. It is also imperative that creating a risk committee does not abdicate all responsibility for risk away from the rest of the directors. A risk committee must communicate with the entire board regularly, and the entire board must accept ultimate responsibility for risk oversight at the corporation. In the words of the SEC, “The turmoil in the markets during the past 18 months has reinforced the importance of enhancing transparency, especially with regard to activities that materially contribute to a company’s risk profile.” SEC Release Nos. 33-9052; 34-60280, Proxy Disclosure and Solicitation Enhancements (July 10, 2009), *available at* <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.

In considering a stand-alone risk committee or re-evaluating current risk oversight, some of the questions a board should be asking<sup>2</sup> include:

- How does the board implement and manage its risk management function, through the board as a whole or through a committee, such as the audit committee?
- Do the individuals who oversee risk management report directly to the board as whole, to a committee, such as the audit committee, or to one of the other standing committees of the board?
- What systems are in place to allow the board and board committees to monitor risk?
- Does the board understand the risks inherent in the corporate strategy?
- Are the board and executive management on the same page as to the company's risk appetite?
- Is there communication about risk and risk appetite to and from the board on a timely basis? Are major corporate functions consistent with this appetite?
- What kind of agenda time does the board dedicate to discussing risks?
- Does the board have adequate internal or external resources to understand emerging risks from a technical, regulatory or litigation perspective? Is the board considering external or unconventional risks, like IT risk?
- Does the board communicate risk to shareholders? If so, how?
- Are the board and management setting a proper "tone at the top" with regard to risk management? Does that translate to a proper tone at the bottom?
- Does the company have the right people in place to manage risk from a technical and tone perspective?
- Does the company have a chief risk officer and is he or she the right fit?
- What, if any, are the specific duties performed by the board's chair or independent lead director with regard to risk?

These same questions should be asked by a skilled insurance broker when crafting your D&O coverage program. To discuss whether your D&O program reflects the changing burdens of risk oversight by the board and your individual company's corporate governance strengths and weaknesses, contact any of the individuals in USI's MPS team.

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<sup>2</sup> This list includes questions suggested by the SEC in its releases on the disclosure rules.

*should always consult knowledgeable counsel for any specific legal questions they may have.*

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