

**CORNERSTONE BANCSHARES, INC. &  
CORNERSTONE COMMUNITY BANK  
POLICY STATEMENT  
CONFLICT OF INTEREST/CODE OF ETHICS**

Date of Last Revision March 2006

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**STATEMENT OF NEED AND DEFINITION**

The Board of Directors (the “Board”) of Cornerstone Bancshares, Inc. and Cornerstone Community Bank (collectively the “Bank”) acknowledges the risk that conflicts of interest may arise in obtaining persons involved in the business and civic community to act as directors, senior officers, and employees of the Bank. Because of such persons’ worth in attracting and maintaining business relationships, the Board feels it prudent to adopt a conflict of interest/code of ethics policy.

**THE PURPOSE**

In recognizing that excessive activities and gratuities and access to information may lead to conflicts of interest for employees, directors, and principal shareholders, the Bank has developed this policy to recognize such positions and to prevent a loss of objectivity by requiring appropriate and trustworthy conduct.

**GENERAL OBJECTIVES OF CONFLICT OF INTEREST POLICY**

The general objective of this policy is to require immediate disclosure of any potential conflict of interest and to prevent such a situation from arising. Adherence to this policy should prevent the development of improper relationships between financial institution directors, officers, employees, and the customers they serve.

**SPECIFIC GOALS**

The specific goals of this policy are to:

- A. Establish a monetary limit on nominal gifts and gratuities.
- B. Describe situations in where possible conflicts of interest may occur and to require proper conduct of all employees and directors.
- C. Require reporting of conflicts to superiors and written disclosures of business interests.
- D. Identify behavior that interferes with the Bank’s “Mission and Values”
- E. Identify behavior that may result in unfavorable publicity toward the Bank
- F. Identify behavior that is not in compliance with governmental laws, rules and regulations which are applicable to the Bank’s operations

## **POLICY ELEMENTS**

### **Authority**

The Board is ultimately responsible for establishing specific policies to address potential conflicts of interest for directors, senior officers, and employees of the Bank. The authority to implement policy and related procedures has been assigned to the Chief Executive Officer and the President.

Any action taken regarding inappropriate insider activities or a breach of the Bank's code of ethics will ultimately be reviewed and acted upon by the entire Board, after considering the facts, the seriousness of the conduct, and any potential breach of trust.

The Board will review this policy annually. This review, and any necessary amendments, will be noted in the Board minutes.

### **Risk Management**

In addressing conflicts of interest, the Board and senior management must be aware of the potential risks arising from insider abuse and subsequent market reaction. In establishing a Conflict of Interest/Code of Ethics Policy, the Board has evaluated various related risks; these risks, and their related management techniques, include:

- *Compliance Risk.* Maintaining legal compliance with various appropriate regulations as well as compliance with the organization's Code of Ethics.
- *Reputation Risk.* Developing and retaining marketplace confidence in handling customers' financial transactions in an appropriate manner as well as protecting the safety and soundness of the Bank.

### **Definitions**

For the purposes of this policy, the following definitions apply:

- *Officer or Employee.* A part-time or full-time salaried officer or employee of the Bank
- *Gift.* May include cash or property, special discounts, price concessions, special personal items, special personal entertainment (other than of a normal social nature), special personal services, gratuitous personal services, personal favors, or special dispensations of any kind attributed to the recipient's position or responsibilities with the Bank
- *Immediate Family.* Spouse, minor child, and/or other dependent of the officer, employee, or director

For definitions of company, control of a company or bank, and principal shareholder and/or related interest, refer to 12 CFR 215, Regulation O.

### **Policy Statement**

Due to the increased number of financial institution failures resulting from self-dealing, fraud, and misconduct of directors, management, and employees, the Board of the Bank intends to hold its employees and directors to this strict code of ethics and to require reporting of conflicts of interest. Individuals associated with the Bank have a primary responsibility to uphold the standards of the Bank.

Failure to comply with all policies herein described may result in disciplinary action up to and including the termination of employment.

All employees and representatives of the Bank are required to act in a responsible and respectable manner and to remain free of influences resulting in the loss of objectivity regarding business conducted with the Bank's customers or with the Bank itself. The Bank requires behavior from our employees and directors that exhibit the highest degree of integrity, honesty, discretion and professionalism in both business and personal conduct. Each employee must disclose and avoid any interests or activities involving another organization or individual resulting in a conflict of interest between the Bank and that organization or individual.

While this policy does not intend to interfere with the personal lives of employees and representatives, it requires those persons to recognize situations where conflicts of interest may arise and to avoid them when possible. If these situations cannot be avoided, they must be reported immediately to a direct superior. Subsequently, the employee or representative should be removed from any compromising situations, whether it involves advising the other person or entity or approving or voting on extensions of credit.

### **Confidential Information**

All employees and directors must acknowledge that all information concerning the Bank, customer, depositor, and director information is considered confidential and is to be used for Bank purposes only. The use of such information for personal, familial, or other gain is unethical and illegal under securities rulings and the National Bank Act. Information regarding any business conducted cannot be disclosed to outside individuals (unless authorized by the Bank or its customer, etc.) and may not be used for personal gain.

It is the Bank's policy to cooperate with all reasonable requests from governmental authorities and each employee and director must do the same. Documents should not be concealed, altered or destroyed in anticipation of, or in response to, any investigation. Any request for information from a governmental authority, other than routine items requested in the ordinary course of business, should be reported to the Chief Executive Officer, or to the Chairman of the Board's Audit Committee so that the Bank may consult its legal counsel about the request prior to providing any information.

Use of confidential information for other than the Bank's business purposes may result in disclosure of insider information. Insider information is defined as information of a material nature to affect the price of the Bank's stock. Insider information may not be used to purchase, trade, or solicit securities until the information is available to the general public.

In addition, all published information (both for internal and external use), developed programs, equipment, etc. are the property of the Bank and are reserved for use by employees of the Bank. Use of these materials for any other purpose may constitute copyright infringement and theft.

## **Established Internal Controls**

Proper disclosure and reporting of financial information is the primary responsibility of the Chief Executive Officer, the President and the Chief Financial and Accounting Officers. However each employee and director has an obligation to insure proper accounting practices are followed and, if not, to notify the Bank's Audit Committee of suspected improprieties. Improper accounting activities include, but are not limited to, the following:

- Improper recording and reporting of financial information that is contrary to Generally Accepted Accounting Principles or Financial Accounting Standards Board's interpretations or pronouncements. This would include the non-recording and reporting of financial information as well.
- Improper accounting of client transactions. Improper or incorrect rating of client loans.
- Improper disclosure of information to regulatory agencies, including non disclosure of information that may be pertinent.
- Improper disclosure of financial information to non regulatory, outside sources not previously disclosed publicly.

The Bank has established a system of internal controls which executive management deems to be reasonable to assure the Board and the shareholders that the assets of the Bank are properly safeguarded. Any employee or director who overrides this system of internal control, whether the employee or director may or may not benefit personally, will not be tolerated. In accordance with the rules promulgated by the Securities and Exchange Commission under the Sarbanes-Oxley Act of 2002, it shall be unlawful and a violation of this policy for any employee or director of the Bank, or any person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate or mislead any independent or certified accountant engaged in the performance of an audit of the Bank's financial statements for the purposes of rendering such financial statements materially misleading.

The Chief Executive Officer, the President and all senior financial officers, including the Chief Financial Officer and the chief Accounting Officer, are responsible for full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the Bank with the Securities and Exchange Commission. Accordingly, it is the responsibility of the Chief Executive Officer, the President and the senior financial officers, individually, to promptly bring to the attention of the Bank's Audit Committee any material information of which may affect the disclosures made by the Bank in its public filings. Such information may include, but not be limited to, the following:

- Significant deficiencies and material weaknesses in the design or operation of the Bank's internal control over financial reporting which are reasonably likely to adversely affect the Bank's ability to record, process, summarize and report financial data
- Any fraud, whether material or not, that involves management, directors or other employees who have a significant role in the Bank's financial reporting, disclosures or internal control over financial reporting

## **Investment in Stock**

The employees of the Bank are encouraged to purchase and hold stock of the Bank for long-term investment. While the Bank may not delve into the personal lives of its employees, employment in a bank requires prudent and proper conduct in investment and other situations. Based on "Insider Information and Knowledge," speculative buying and selling of Bank stock is prohibited.

## **Conflicts of Interest**

A conflict of interest occurs when an employee or director's individual private interest interferes, or appears to interfere, in any way with the interests of the Bank. If any employee or director believes that they may have, either directly or indirectly, an actual or potential conflict of interest, or they are aware of a transaction or relationship that reasonably could be expected to give rise to such a conflict, the employee or director should immediately report it to the Chief Executive Officer, the President or to the Bank's Audit Committee.

Each employee and director should administer their affairs in a manner well above criticism, particularly those affairs involving a Bank employee, director, client, borrower, vendor, competitor or other party. Employees and directors should avoid situations that may lead to a conflict or the appearance of a conflict. A conflict of interest is a situation involving a third party whereby it would appear that an employee or director is the beneficiary from a particular circumstance or transaction. A conflict of interest can also arise when an employee or director takes actions or has interests that may make it difficult to perform their responsibilities objectively and effectively.

## **Gifts and Entertainment**

Employees of the Bank are not to solicit gifts from prospective or current customers, associates, or any other individual or business that are not within generally accepted business practices. Any gifts received, not within generally accepted business practices, shall be of nominal value. Nominal value is considered to be anything below \$25.

Employees of the Bank are expected to participate in entertainment and amenities of reasonable cost to facilitate business. Payment by anyone other than the Bank of excessive costs or travel not customary or within acceptable business practice must not be accepted. Any questionable circumstances must be reported to your immediate supervisor.

Tickets for sporting, cultural, or other events purchased by the Bank are to be used in entertaining potential or actual customers, vendors, or others for business purposes only. The Bank will not tolerate an employee or director giving any gift, bribe, kickback, favor, discount or any other item to a client, potential client or any other party with the intent of influencing that party's decision in a transaction or potential transaction involving the Bank that is not within generally accepted business practices.

## **External Involvement**

While the Bank encourages its employees to be involved in outside activities, including charitable and political functions, federal law prohibits the Bank from making political contributions. At no time will employees solicit other employees for political contributions or coerce others into contributing to any organization. Conduct must not give the perception that benefit to the Bank or connections are sought or desired.

Additionally, offers of directorship to any outside organization having or desiring a business relationship with the Bank, or to any institution within the financial industry, must be reported to the President prior to acceptance.

Capitalizing on opportunities for personal gain or compensation outside of that provided by the Bank for the performance of services for the Bank is strictly prohibited. Employment outside and in addition to employment at the Bank must be reported to your immediate supervisor.

## **Consultation**

Refer any questions regarding proper code of conduct to an immediate supervisor. Actions or acceptance of gifts not specifically mentioned above must be reviewed as to intent and purpose. Employees should ask

themselves: “If a situation were to be made public, would my conduct be embarrassing or come into question?”

### **Conduct of Insiders**

12 CFR § 215, or Federal Regulation O, defines “insiders” as directors, executive officers, and principal shareholders. These people must take care that their conduct does not violate rules relating to self-dealing and personal gains. At no time are members of this group allowed to take advantage of their position in the Bank for personal profit or influence over credit and other decisions with regard to their business or personal interests.

Directors and officers are prohibited from being involved in the loan approval process of insiders who may benefit directly or indirectly from the decision to grant credit. This prohibition extends to professional relationships with any company or firm receiving remuneration as a result of the decision to grant credit.

Decisions regarding the sale or purchase of Bank assets and services must be made in the best interests of the Bank, with no influence on insiders resulting from gifts, entertainment, or gratuities. All conduct of such business must be at “arm’s length.”

### **Disclosures**

Employees and officers of the Bank must make annual disclosures of any relationships, receipt of gifts, compensation, or other situations leading to possible conflicts in the following manner:

Employees:	Report to immediate supervisor
Officers:	Report to the Chief Executive Officer or the President
Executive Officers, President, and all directors:	Report to the Board’s Audit Committee

Directors, principal shareholders, and executive officers must make annual disclosures to the entire Board of any actual and potential conflicts of interest and any potential conflicts of their related interests.

### **Employee Accounts**

All employees are encouraged to maintain their bank accounts at the Bank to allow the Bank to provide service and direct deposit of payroll checks. However, under no circumstances will the Bank pay a rate of interest in excess of the rate available to all other customers.

All applicable fees, including overdraft charges, will be assessed on all accounts of directors, principal shareholders, and executive officers. One overdraft fee will be waived per calendar quarter.

### **Consequences of Noncompliance**

As previously stated, failure to comply with this policy may result in disciplinary action up to and including the termination of employment. The action taken will be commensurate with the seriousness of the conduct and an evaluation of the situation.

All violations of this policy will be brought to the attention of the Board.

### **In the Procedures**

Management is responsible for developing and implementing procedures to ensure proper disclosure as required by this policy. Management is also responsible for maintaining documentation of compliance with this policy.

On an annual basis, an audit will be conducted to review the procedures, documentation, and minutes of the Board meetings to test for compliance with this policy. The findings will be disclosed to the Audit Committee of the Board.