**AFR** Americans for Financial Reform

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

RE: Docket No. OP-1570; Proposed Guidance for Supervisory Expectations on Boards of Directors

On behalf of Americans for Financial Reform, we are writing to comment on the Federal Reserve Board's (the "FRB's") proposed guidance for supervisory expectations on boards of directors (the "Guidance"). Americans for Financial Reform is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.[1]

The 2008 financial crisis was marked by a large-scale failure of corporate governance, including the failure of boards of directors to monitor or understand the risks their companies were taking.[2] During the post-crisis period, although a range of rules have been put in place requiring more effective management and monitoring of bank risks by boards of directors, we have unfortunately continued to see some significant failures of board oversight. Examples include the failure of JP Morgan's board to ensure proper oversight of trading activities, which led to a multi-billion dollar trading loss, and the failure of the Wells Fargo board of directors to properly monitor massive consumer fraud at the bank.

This Guidance proposes a significant change in supervisory expectations for boards of directors, based on the idea of creating greater clarity on the division of responsibilities between bank boards of directors and senior management. The concern expressed in the Guidance is that boards of directors are being distracted from their core responsibilities by a large number of new supervisory expectations, expectations that in many cases are better directed to senior management. In response, the Guidance lays out a new formulation of supervisory expectations for boards of directors, a list of supervisory letters in which will be revised in light of this new guidance, and finally proposes specific revisions for SR 13-13, "Supervisory Considerations for the Communication of Supervisory Findings". Included in the Guidance are a new proposed text laying out key elements for "Board of Directors Effectiveness" and a new "Proposed Guidance on the Communication of Supervisory Findings" to replace the current SR 13-13.

We agree that it is important to distinguish the role of the board of directors from the role of senior management. We also agree that the five very general standards set out in the Guidance for effective boards (setting firm strategy, managing information flow, holding senior

[1] A list of members of the AFR coalition is available at http://ourfinancialsecurity.org/about/our-coalition/

[2] Organization for European Cooperation and Development, ***Corporate Governance and the Financial Crisis***, Accessed 10/09/17, http://bit.ly/2yXhGlD . Kirkpatrick, Grant, "Corporate Governance Lessons From the Financial Crisis", OECD Financial Market Trends, 2009. http://bit.ly/2xwQXjy

management accountable, support effective risk management, and maintain capable board composition and governance structure) are a reasonable list of supervisory expectations for boards of directors.

However, in light of the highly abstract and general nature of the standards for board performance set out in the Guidance, we are concerned that the implementation of these standards may lead to a major decline in supervisory expectations for board accountability. Our concern is greatly heightened by the text of the new "Proposed Guidance on the Communication of Supervisory Findings" proposed in this Guidance. This new Proposed Guidance would end the practice of routinely notifying the board of directors of supervisory findings that include critical information on bank senior management performance and the current state of bank risk management. In our view, the current SR 13-13 guidance in the main properly differentiates between the role of the board and senior management, and those elements of it that might put excess burdens on the board could be easily modified without taking the radical step proposed in this Guidance. We urge the FRB to maintain the current SR 13-13 practice of routinely informing boards of directors of these findings.

While the new proposed replacement for SR 13-13 is the most detailed change in supervisory standards fully described in this letter, the weakening of that supervisory letter also raises concerns about the other letters listed for modification in the Guidance.

Finally, we find it striking that this Guidance does not engage in a more concrete and detailed manner with several issues critical to board effectiveness and incentives. This includes the issue of board qualifications and outside commitments, particularly in light of recent research showing overcommitted boards to be a serious issue, and the issue of board of director fiduciary responsibility and accountability (including personal liability). We suggest below that greater engagement with these issues would be beneficial in ensuring board effectiveness.

***Proposed Modification to SR 13-13***

Contrary to the implication in the Guidance that the current SR 13-13 letter blurs the role of the board and senior management, the current SR 13-13 letter specifically states:

> "the board itself may not directly undertake the work to remediate supervisory findings as senior management is responsible for the organization's day-to-day operations, it is nevertheless important that the board be made aware of significant supervisory issues and ultimately be accountable for the safety and soundness and assurance of compliance…of the organization".

We see no contradiction between this statement and the principle that there should be a clear division between the operational responsibilities of the board and senior management. We agree wholeheartedly with the current SR 13-13 letter that the board should routinely be made aware of significant supervisory issues as part of its fundamental accountability for the performance of senior management and the organization as a whole.

Note that the current SR 13-13 letter applies only to Matters Requiring Attention (MRAs) and Matters Requiring Immediate Attention (MRIAs). These are by definition significant and important supervisory issues. Indeed, the current letter defines MRIAs as "matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately" and involve significant risk to safety and soundness, significant risk of non-compliance with applicable laws, and/or significant risk of consumer harm.

The current SR 13-13 could easily be modified to reduce the administrative burden on the board while still keeping the board routinely informed of these critical supervisory matters. For example, the current letter could be modified to alter the requirement that "the banking organization's board of directors…respond to the Reserve Bank in writing regarding corrective action taken or planned along with a commitment to corresponding timeframes". The responsibility of a written response to supervisors laying out the organization's plan to remediate negative findings could instead be given to senior management, rather than the board of directors, making clear that the actual responsibility for implementing corrective action lies with senior management.

But the proposed revisions in the supervisory letter laid out in this Guidance appear to go well beyond these reasonable changes. Instead, the revised letter directs supervisors to communicate significant findings only to senior management, not to the board of directors, and to "escalate such matters" to the board of directors only when senior management "fails to take or ensure appropriate action is taken" on supervisory findings. This would apparently be true even in the case of MRIAs, which are defined as urgent matters requiring rapid action. The revised letter appears to place the responsibility for the communication of new supervisory findings to the board of directors solely with senior management.

Abandoning the practice of routine supervisory notification of the board of directors concerning crucial examination findings seems unreasonable on its face. An ineffective senior management would face obvious incentives not to communicate significant supervisory findings to the board until such communication was unavoidable. It is hard to see any reason why the board of directors should not at least be made aware of vital and time-sensitive supervisory findings at the same time senior management is. By placing the board of directors "out of the loop" of routine communication of important supervisory concerns, the revised letter would reduce the effectiveness of board oversight.

This policy change is also unjustified based on the proposed new supervisory directives concerning the effective attributes of boards of directors that are included in this Guidance. This guidance states that "an effective board has processes and practices in place to evaluate information flows and to engage senior management on improvements" and "engages in robust and active inquiry into…material or persistent deficiencies in risk management and control practices" as part of holding senior management accountable.

It is difficult to see how these and other characteristics of an effective board would be compatible with simply passively waiting to be informed by senior management of the existence of significant and time-sensitive supervisory findings. By adopting a supervisory policy which does not require the board of directors to be promptly be notified of key supervisory findings, the FRB would be signaling that boards of directors need not remain alert to possible failures in compliance and risk management.

We urge the FRB to alter the Proposed Guidance on the Communication of Supervisory findings to provide that the board be routinely notified of MRAs and MRIAs at the same time as they are delivered to senior management. This could be done while continuing to make clear that the primary responsibility for actually taking corrective action in response to these supervisory findings rests with senior management.

***Other Concerns***

The Guidance lists dozens of additional supervisory letters which are to be revised in the light of the new proposed guidance on characteristics of effective boards of directors. The list of supervisory letters to be modified includes some of the most critical new supervisory policies established in the wake of the global financial crisis, including SR 12-17, the new consolidated supervisory framework for large financial institutions, SR 14-8 on consolidated recovery planning, and SR 08-8 on compliance risk management and oversight. Crucial pre-crisis supervisory letters, such as SR 93-69 on risk management and internal controls for trading, are also included in the list.

All of these letters make clear that the bank board of directors is directly responsible for the performance of the institution. For example, SR 12-17 states that the board of directors, with support from senior management, must “ensure the organization’s internal audit, corporate compliance, and risk management and internal control functions are effective and independent”, “ensure that the firm’s senior management has the expertise and level of involvement required to manage the firm’s core business lines, critical operations, banking offices, and other material entities”, ensure the effectiveness of management information systems, and in other ways assure that the bank is well managed. SR 08-8 states that the board of directors are “responsible for setting an appropriate culture of compliance within their organizations, for establishing clear policies regarding the management of key risks, and for ensuring that these policies are adhered to in practice.” SR 93-69 states that the board of directors “should approve all significant policies for the management of risks throughout the institution”. Examples could be multiplied.

In our view, the supervisory expectations laid out for boards of directors in this Guidance are compatible with the strong statements of board responsibility in these supervisory letters. The statements in the Guidance that the board should “hold senior management accountable”, “support the independence and stature of independent risk management”, and “set clear, aligned, and consistent direction” for the bank’s strategy seem to support the assignment of board responsibilities in the supervisory letters cited above. We would oppose any reading of these principles that significantly weakened board responsibility for the crucial elements of bank performance laid out in the listed supervisory letters. Providing greater clarity as to the division of operational responsibilities between senior management and the board need not and should not weaken the accountability of the board of directors for the bank’s management and performance.

Finally, we believe the Guidance should engage in a more detailed manner with several issues critical to the effectiveness of boards of directors. One such issue is board composition and outside responsibilities. The Guidance correctly specifies that maintaining a capable board composition is a key attribute of effective boards, but offers little concrete guidance in this area. There is also little discussion of outside responsibilities, except for a one word reference to the "availability" of directors.

However, recent research has found that excessive outside commitments by board members at major financial institutions currently pose a serious threat to effective governance at large banks.[3] In light of this, the FRB should provide more specific guidance in relation to the appropriate level of outside commitments. Personal qualifications for board members is another area where a basic supervisory floor for qualifications and diversity of skills seems called for.

Another area which would reward more specific guidance is the fiduciary responsibility of board members and their accountability for this responsibility. Fiduciary responsibilities for bank board members should differ from fiduciary responsibilities for board members of other corporations, as banks are heavily reliant on debt and bank risk management should take into account the major social externalities that can be created by putting shareholder interests before debt holder interests.[4] This is a justification for bank boards' increased responsibilities in the area of risk management, and would also merit specific supervisory guidance.

Finally, post-financial crisis Delaware court decisions in relation to individual board member liability for the failures of board risk oversight have resulted in apparently fairly limited personal liability.[5] We believe the FRB should examine the issue of whether heightened board member personal liability for key supervisory responsibilities would improve board effectiveness.

Thank you for the opportunity to comment on this Guidance. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org

Sincerely,

Americans for Financial Reform

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[3] Kress, Jeremy C., Board to Death: How Busy Directors Could Cause the Next Financial Crisis (June 22, 2017). 59 B.C. L. Rev. ___ (2018 Forthcoming); Ross School of Business Paper No. 1370. Available at SSRN: https://ssrn.com/abstract=2991142

[4] Hopt, Klaus J., Better Governance of Financial Institutions (April 1, 2013). "Corporate Governance of Banks and Other Financial Institutions After the Financial Crisis", Journal of Corporate Law Studies 13 Part 2 (2013) 219-253 (Part B); "Corporate Governance of Banks after the Financial Crisis", in: E. Wymeersch, K. J. Hopt, G. Ferrarini, eds., Financial Regulation and Supervision, A post-crisis analysis, Oxford University Press 2012, pp. 337-367 (Part A); ECGI - Law Working Paper No. 207. Available at SSRN: https://ssrn.com/abstract=2212198

[5] In Re Citigroup Inc. Shareholder Derivative Litigation, No. 3338-CC (Feb. 24, 2009); http://www.wlrk.net/docs/1386729_1.pdf