

Via E-Mail

November 16, 2017

Ms. Ann E. Misback  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue NW  
Washington, DC 20551

Re: FR 3077- Proposed Guidance on Supervisory Expectation for Boards of Directors<sup>1</sup>

Dear Madam Secretary:

I am writing in response to the Federal Reserve Board's (FRB) proposal addressing supervisory expectations for the boards of directors of certain financial institutions (Proposed Guidance). The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management exceeding \$3 trillion.

Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than \$20 trillion in assets under management.<sup>2</sup>

As the leading voice of corporate governance in the United States, we support the FRB's efforts to "refocus supervisory expectations for boards on a board's core responsibilities."<sup>3</sup> We agree that boards spending too much time satisfying supervisory expectations not directly related to the board's core responsibilities can damage board effectiveness, and that financial institution boards at present can be overwhelmed by the quantity and complexity of information they receive.

We support the following view espoused by FRB Governor Jerome H. Powell about the intent and purpose of the Proposed Guidance:

We do not intend that these reforms will lower the bar for boards or lighten the loads of directors. The new approach distinguishes the board from senior management so that we can spotlight our

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<sup>1</sup> Proposed Guidance on Supervisory Expectation for Boards of Directors, Docket No. OP—1570, 82 Fed. Reg. 37,219 (Aug. 9, 2017), <https://www.gpo.gov/fdsys/pkg/FR-2017-08-09/pdf/2017-16735.pdf>.

<sup>2</sup> For more information about the Council of Institutional Investors ("CII"), including its members, please visit the CII's website at <http://www.cii.org/members>.

<sup>3</sup> 82 Fed. Reg. at 37,219.

expectations of effective boards. The intent is to enable directors to spend less board time on routine matters and more on core board responsibilities: overseeing management as they devise a clear and coherent direction for the firm, holding management accountable for the execution of that strategy, and ensuring the independence and stature of the risk management and internal audit functions. These were all areas that we found wanting in the financial crisis, and it is essential that boards get these fundamentals right.<sup>4</sup>

That said, we have some concern that while bank boards have been required to be too much in the weeds on some matters, the pendulum could swing too far in the opposite direction. The FRB notes the inherent information disadvantage of outside board members vis-à-vis management. This puts a priority on appropriate board knowledge and skill sets, including on members with rich understanding of banking and financial institutions more broadly, who can ask the right questions and understand key sources of risk.

“History shows that bank directors struggle to identify TGTBT [too good to be true] performance,” wrote Richard J. Parsons, formerly of an executive with Bank of America, in *American Banker* in 2016.<sup>5</sup> He adds that “directors too often lack the detailed knowledge of banking to challenge management’s perspective on performance.”<sup>6</sup>

Problems of asymmetric information and challenges in information flow also put a premium on effective leadership of independent directors. Finally, while we understand the basis for greater selectivity in information that regulators direct to boards, we believe the proposed guidance on communication of supervisory findings goes too far, and uses confusing terminology.

We offer the following specific comments in response to certain of the questions posed by the Proposed Guidance.

### **What other attributes of effective boards should the Board assess? (Question 2)<sup>7</sup>**

We generally agree that the proposed board effective (BE) guidance “better distinguishes the supervisory expectations for boards from those of senior management . . . .”<sup>8</sup> However, we believe the proposed BE guidance potentially could be enhanced in sections D & E as described in more detail below.

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<sup>4</sup> Federal Reserve Governor Jerome H. Powell, Address at The Large Bank Directors Conference, Chicago, Ill. 3 (Aug. 30, 2017), <https://www.federalreserve.gov/newsevents/speech/files/powell20170830a.pdf>.

<sup>5</sup> Richard J. Parsons, “BankThink, Why Wells Debacle is Cautionary Tale for Bank Boards,” *Am. Banker*, Sept. 19, 2016, at 1, <https://www.americanbanker.com/opinion/whv-wells-debacle-is-cautionary-tale-for-bank-boards>. Mr. Parsons is not to be confused with former Citigroup Chairman Richard Parsons, although we assert that a hallmark of the latter’s tenure as Citigroup Chairman was strengthening of industry knowledge on Citigroup’s board.

<sup>6</sup> *Id.* at 2.

<sup>7</sup> 82 Fed. Reg. at 37,223.

<sup>8</sup> *Id.* at 37,220.

#### D. Support the Independence and Stature of Independence Risk Management and Internal Audit<sup>9</sup>

We believe independence is critical to a properly functioning board, and we do not believe independence is inconsistent with sufficient deep industry knowledge.<sup>10</sup> We therefore generally support section D of the BE guidance. However, given the importance of board independence, the FRB should consider whether additional principles-based guidance on board independence might be appropriate. In that regard, CII's membership approved policies provide extensive guidelines for assessing director independence.<sup>11</sup>

At a minimum, the FRB might consider enhancing the section D guidance consistent with our basic definition of board independence which states:

An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship. Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.<sup>12</sup>

#### E. Maintain a Capable Board Composition and Governance Structure<sup>13</sup>

We generally support section E, as well as section C, which also offers comments on board structure.<sup>14</sup> However, we believe the FRB should consider whether additional guidance on director skill sets and experience, board leadership, outside commitments by board members, and board diversity might be appropriate.

##### Skill Sets and Experience

We believe it is critical that section E discuss the need for some outside directors with relevant industry experience and subject-matter expertise. The text of this section is very high-level and abstract, and we worry that the language will signal to banks acceptance of or even approval for return to a model of having only generalists on bank boards. We believe there is real risk in reversing efforts since 2008 to include more subject-matter experience as a critical element in forming a strong, diverse board.

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<sup>9</sup> Id. at 37,225-26.

<sup>10</sup> CII, Corporate Governance Policies, § 7.1 Introduction (last updated Sept. 15, 2017), [http://www.cii.org/files/policies/09\\_15\\_17\\_corp\\_gov\\_policies.pdf](http://www.cii.org/files/policies/09_15_17_corp_gov_policies.pdf).

<sup>11</sup> § 7.3 Guidelines for Assessing Director Independence.

<sup>12</sup> § 7.2 Basic Definition of an Independent Director.

<sup>13</sup> 82 Fed. Reg. at 37,226.

<sup>14</sup> Id. at 37,225-26.

### Leadership of Independent Directors

Our membership approved policy on “Independent Chair/Lead Director states:”

The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.

Other roles of the lead independent director should include chairing meetings of non-management directors and of independent directors, presiding over board meetings in the absence of the chair, serving as the principle liaison between the independent directors and the chair and leading the board/director evaluation process. Given these additional responsibilities, the lead independent director should expect to devote a greater amount of time to board service than the other directors.<sup>15</sup>

We believe a CEO who also serves as chair can exert excessive influence on the board and its agenda, weakening the board’s oversight of management.<sup>16</sup> Separating the chair and CEO positions reduces this conflict, and an independent chair provides the clearest separation of power between the CEO and the rest of the board.<sup>17</sup> Absent an independent chair, we believe a lead independent director with strong and clearly stated responsibilities is essential.

We are concerned that the proposed guidance underplays the importance of effective independent board leadership, referring only to a lead independent director (not our preferred alternative of an independent chair), and describing only limited aspects of lead director responsibilities in section C on holding senior management accountable. Section E, on “governance structure,” does not address board leadership at all.<sup>18</sup>

We note that in 2009, amidst the financial crisis, perceived poor decisions by Bank of America leadership and a huge government bailout of the bank, shareholders, who had seen a 80%+ loss

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<sup>15</sup> § 2.4 Independent Chair/Lead Director.

<sup>16</sup> CII, Independent Board Leadership, [http://www.cii.org/independent\\_board](http://www.cii.org/independent_board).

<sup>17</sup> Id.

<sup>18</sup> 82 Fed. Reg. at 37,226.

in share value, approved a binding proposal for an independent board chair.<sup>19</sup> We believe this was an important part of an effort by shareholders to change bank leadership and set it on a better course.<sup>20</sup>

### Outside Commitments

Our membership approved policy on outside commitments states:

Companies should establish and publish guidelines specifying on how many other boards their directors may serve. Absent unusual, specified circumstances, directors with full-time jobs should not serve on more than two other boards. Currently serving CEOs should not serve as a director of more than one other company, and then only if the CEO's own company is in the top half of its peer group. No other director should serve on more than five for-profit company boards.<sup>21</sup>

We note that consistent with our policy, a recent working paper by a University of Michigan Senior Research Fellow concludes that:

[B]usy directors detract from effective governance at large financial institutions. These institutions, by virtue of their complexity and systemic importance, require enhanced monitoring from their boards—oversight that busy directors are ill equipped to provide. The directors of the United States' largest and most complex financial institutions, however, remain alarmingly busy. Preserving the safety and soundness of the financial system, therefore, requires that financial company directors—and especially those with key board leadership positions—reduce their outside commitments.<sup>22</sup>

Moreover, the paper recommends that the FRB “should prohibit directors of a BHC with \$50 billion or more in assets or a systemically important nonbank financial company from serving on the board of more than three public companies or, if the director is a public company executive, more than two public companies (including his or her own).”<sup>23</sup> While a prohibition might not be

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<sup>19</sup> See, e.g., Ceres et al., “An Investor Response to the U.S. Chamber’s Proposal to Revise SEC Rule 14a-8,” at 11 (Nov. 2017), <http://www.cii.org/files/Investor%20Response%20to%20Chamber%2014a-8%20Nov%209%20Final%202.pdf>.

<sup>20</sup> Id.

<sup>21</sup> § 2.11 Board Size and Service.

<sup>22</sup> Jeremy C. Kress, “Board to Death: How Busy Directors Could Cause the Next Financial Crisis” 41-42 (Steven M. Ross Sch. of Bus., Univ. Mich., Working Paper No. 1370, 2017), available at [file:///C:/Users/jeff.mahoney/Downloads/SSRN-id2991142%20\(1\).pdf](file:///C:/Users/jeff.mahoney/Downloads/SSRN-id2991142%20(1).pdf).

<sup>23</sup> Id. at 40; cf. ISS, “Majority of Investors Favor Tighter ‘Overboarding’ Standards for U.S. Executive Chairs and Adverse Director Recommendations in Wake of Dual-Class IPOs” 1 (Sept. 29, 2017) (Indicating that 64 percent of investors supported a tightening of overboarding standards so that an executive chairman who is not also the

appropriate in all circumstances, we believe the FRB should consider enhanced guidance in proposed section E at least as stringent as our policy.

### Diversity

Our membership approved policy supports a diverse board.<sup>24</sup> Our policy states:

CII believes a diverse board has benefits that can enhance corporate financial performance, particularly in today's global market place. Nominating committee charters, or equivalent, ought to reflect that boards should be diverse, including such considerations as background, experience, age, race, gender, ethnicity, and culture.<sup>25</sup>

Consistent with our policy, we believe the FRB should consider adding the following text or similar language to the end of the second paragraph of section E discussing diversity:

Furthermore, an effective board would consider board nominees that are diverse with respect to background, experience, age, race, gender, ethnicity, and culture.

The proposed change and our policy are supported by the growing body of studies that “shows that companies with more diverse leadership teams perform better financially.”<sup>26</sup>

**Should boards of firms subject to the proposed BE guidance be required to perform a self-assessment of their effectiveness and provide the results of that self-assessment to the Board? If so, what requirements should apply to how the board performs the self-assessment? Should such self-assessments be used as the primary basis for supervisory evaluations of board effectiveness? (Question 3)<sup>27</sup>**

We believe the boards of firms should be required to perform a self-assessment of their effectiveness and provide the results of that self-assessment to the board. Our membership approved policy states:

Boards should review their own performance periodically. That evaluation should include a review of the performance and qualifications of any director who received "against" votes from a

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company's CEO should serve on no more than three total boards), <https://www.issgovernance.com/iss-announces-results-annual-benchmark-voting-policy-survey/>.

<sup>24</sup> § 2.8b Board Diversity.

<sup>25</sup> Id.

<sup>26</sup> See, e.g., Alina Tugend, “Melody Hobson Says the Time for Corporate Diversity is Now,” DealBook/Business & Policy, N.Y. Times, Nov. 14, 2017, at 2, <https://www.nytimes.com/2017/11/14/business/dealbook/melody-hobson-corporate-diversity.html>.

<sup>27</sup> 82 Fed. Reg. at 37,223.

significant number of shareowners or for whom a significant number of shareowners withheld votes.<sup>28</sup>

Our policy is based on the view that “[r]egular and rigorous self-evaluations help a board to assess its performance and identify and address potential gaps in the boardroom.”<sup>29</sup>

In addition to providing the results of the self-assessment to the board, we believe investors should be provided “detailed disclosure of the board evaluation process” to assist shareowners in making voting decisions about directors.<sup>30</sup> Such disclosure is an indication that a board is willing to think critically about its own performance on a regular basis and tackle any weaknesses.<sup>31</sup> We believe proposed BE guidance requiring a board self-assessment—and disclosure of the evaluation process—can be an important catalyst for “refreshing” the board as new needs arise.<sup>32</sup> Moreover, it can enhance long-term shareowner value and the supervisory evaluation of board effectiveness.<sup>33</sup>

**Is the proposed guidance on the communication of supervisory findings clear with respect to the division of responsibilities between the board and senior management? (Question 5)<sup>34</sup>**

No, the guidance is not clear, and appears to go too far in limiting information going to boards. It is not clear to us that even Matters Requiring Immediate Attention (MRIAs) would be provided to boards.

MRIAs involve matters that have the potential to pose significant risk to the safety and soundness of the institution; or that represent significant non-compliance with applicable law or regulations; or that involve repeat criticisms that have escalated in importance due to insufficient attention or inaction by the institution; or that have the potential to cause significant consumer harm. We are doubtful that the FRB intends to cut off direct communications to the board on such matters.

The guidance provides the option of providing key information to “an executive-level committee of the board.”<sup>35</sup> We are not sure what that means.

As “executive” often refers to “senior management,” this language is confusing. Moreover, some boards have “executive committees,” often dormant except in emergencies, and at times composed of inside directors and one or two outside directors very close to the CEO. We do not

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<sup>28</sup> § 2.8c Evaluation of Directors.

<sup>29</sup> CII, Best Disclosure: Board Framework 2 (Sept. 2014),

[http://www.cii.org/files/publications/governance\\_basics/08\\_18\\_14\\_Best\\_Disclosure\\_Board\\_Evaluation\\_FINAL.pdf](http://www.cii.org/files/publications/governance_basics/08_18_14_Best_Disclosure_Board_Evaluation_FINAL.pdf).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> See *id.*

<sup>34</sup> 82 Fed. Reg. at 37,227.

<sup>35</sup> *Id.*

believe that the FRB intends to provide an option to limit disclosure to such a body where senior management fails to take or ensure appropriate action is taken to correct material deficiencies or weaknesses.

We would go further and say such failure to take corrective action is very serious, and in all cases should be communicated by examiners and supervisory staff to the full board. We can see no justification for leaving some members of a board of directors in the dark on such findings. Clearly failures of board governance structure appropriately would be directed to the full board, as indicated in the guidance.

More generally, we are concerned that the language in the guidance does not accomplish what Governor Powell described in comments he made August 30.<sup>36</sup> We urge the FRB to consider strengthening the guidance language to more closely reflect Governor Powell's description. Further, we believe bank investors would be reassured if the disclosure guidance more explicitly connected with section B, such that it is clear that bank boards will receive a sufficiently robust information flow directly from examiners and supervisory staff to do the job described by Governor Powell.

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Thank you for consideration of our views. If we can answer any questions or provide additional information, please do not hesitate to contact me at 202.822.0800 or [jeff@cii.org](mailto:jeff@cii.org).

Sincerely,



Jeffrey P. Mahoney  
General Counsel

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<sup>36</sup> “While we have proposed that most MRAs [Matters Requiring Attention] and MRIAs be addressed in the first instance to management and not to the board, the board would continue to receive MRAs where board practices are at issue or where management has failed to promptly and adequately take the required actions. The board would also continue to receive copies of examination and inspection reports, including formal communications with the institution. In the parlance of the proposed guidance I just outlined, we fully expect the board to actively manage the information flow related to MRAs and to hold management accountable for remediating them. In doing so, a board may choose to track progress and closure of MRAs through an appropriate board committee, rather than getting into the granular detail on every individual MRA.” Powell, op. cit.