February 15, 2018

VIA E-MAIL

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Secretary, Board of Governors of the Federal Reserve System
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Re: Comments on the Proposed Guidance on Supervisory Expectation for Boards of Directors (Dkt. No. OP-1570) and Proposed Rulemaking on Large Financial Institution Rating System; Regulations K and LL (Dkt. No. R-1569).

Dear Ms. Misback:

I appreciate the opportunity to submit, on behalf of the 16 undersigned business, legal, and public policy scholars, comments to the Federal Reserve's proposed guidance on supervisory expectation for certain boards of directors and the corporate governance aspects of the proposed rulemaking to establish a new rating system for supervising certain large financial institutions.[1] The scholars bring decades of expertise in financial regulation, corporate governance, and related areas that they gained while working in academia, the private sector or the U.S. federal government, including at the Federal Reserve System ("Federal Reserve") and the U.S. Department of the Treasury ("Treasury"). In short, the scholars believe the proposed changes would be a step backwards for the safety and soundness of the U.S. financial system, as well as the rule of law in the United States.

The federal government has ample reason to believe the legal regime governing the boards of directors of large, complex financial institutions is failing to stop or sufficiently minimize the misconduct long bedeviling these institutions and at times causing harm to the U.S. financial system, the customers of these institutions, and American taxpayers. Among these and other reasons, in 2011, the Financial Crisis Inquiry Commission concluded that "dramatic failures of corporate governance and risk management at many systematically important financial institutions were a key cause of [the] crisis."[2] Since then, several federal agencies have brought numerous actions against the parent company or related entities of large, complex

[1] Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 FR 37219, 37219-37227 (Aug. 9, 2017) (the "Proposed Guidance"); Large Financial Institution Rating System; Regulations K and LL, 82 FR 39049, 39049-39062 (Aug. 17, 2017) (the "LFI Ratings Rulemaking").

[2] *The Financial Crisis Inquiry Report* (Jan. 2011), at p. xviii, *available at* https://fcic.law.stanford.edu/report.

financial institutions to resolve criminal, civil, or regulatory misconduct that occurred post-crisis. Regardless of whether the misconduct is proven or admitted, the frequency with which the government believes it has sufficient evidence to bring these allegations suggests that the legal regime, either as written, applied, or enforced, is fundamentally flawed.[3]

While certain leaders or agencies have taken limited action to address this problem, either pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") or independent action, the federal financial agencies have failed to take a collective look at the problem and adopt a coordinated solution.[4] For example, although the primary regulator of the large national banks (the Office of the Comptroller of the Currency, or "OCC") set new governance standards in 2014 for the boards of large national banks, the Federal Reserve did not issue equivalent, complementary standards for the boards of large holding companies, which often own the large national banks.[5] Meanwhile, in the Federal Reserve's own assessment, many of the large, complex financial institutions still pose serious risk to the U.S. financial system.[6]

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[3] For a few reasons, the scholars have not attempted to quantify these enforcement actions. For example, the federal government (1) has no single database or other tool to identify all the government enforcement actions (public or non-public) against a corporate entity or enterprise, (2) does not use a uniform coding system for enforcement actions, and (3) does not always identify the period of misconduct (whether alleged or admitted) in the public document reflecting the settlement. Not having such systems and tools creates inefficiencies and potentially critical knowledge gaps for the government and regulated entities, among others. For examples of these enforcement actions, and without endorsing the accuracy or completeness of this work, see Philip Mattera's enforcement record summaries at http://www.corp-research.org/corporaterapsheets.

[4] *See, e.g.*, William Dudley, *Banking Culture - Still Room for Improvement?* (Feb. 7, 2018) (transcript of panel discussion), *available at* https://www.newyorkfed.org/newsevents/speeches/2018/dud180209; Janet Yellen, *Improving the Oversight of Large Financial Institutions* (Mar. 3, 2015), *available at* https://www.federalreserve.gov/newsevents/speech/yellen20150303a.htm; William Dudley, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry* (Oct. 20, 2014), *available at* https://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html; Thomas J. Curry, *RMA's Governance, Compliance, and Operational Risk Conference* (May 8, 2014), *available at* https://www.occ.treas.gov/news-issuances/speeches/2014/pub-speech-2014-69a.pdf.

[5] OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations, 79 FR 54518, 54518-54549 (Sept. 11, 2014), *available at* https://www.gpo.gov/fdsys/pkg/FR-2014-09-11/pdf/2014-21224.pdf. An appendix to the OCC's safety and soundness standards regulations, the guidelines establish standards for the design and implementation of a risk governance framework for subject institutions, and impose new or clarified requirements relating to board composition and responsibilities. For example, the guidelines instruct board directors to "actively" oversee the bank's risk-taking activities and hold management accountable for adhering to the bank's risk governance framework. Further, the guidelines require the board to perform an annual self-assessment that includes an evaluation of the board's effectiveness in meeting the minimum standards.

[6] The Federal Reserve's Large Institution Supervision Coordinating Committee ("LISCC") maintains its list of systemically important financial institutions at https://www.federalreserve.gov/supervisionreg/large-institution-supervision.htm.

EXECUTIVE SUMMARY OF COMMENTS

As explained below, it is long overdue for interested agencies to collectively develop and enforce a legal regime for the boards of holding companies that will stop or sufficiently minimize the misconduct long bedeviling these institutions and members of their enterprise. To develop that regime, the agencies should work together, exercise existing statutory authority (which is considerable), and make requests to Congress for more authority or resources, if needed. If the Federal Reserve proceeds without seeking more input, the agency should still amend its proposals as described below.

First, the Federal Reserve should amend its proposed text for the supervisory guidance on board of directors' effectiveness to (1) incorporate expected outcomes for the boards; (2) require boards to select directors who have not only the right skills, knowledge, experience and perspective, but also the time necessary to do their jobs well, including their legal and regulatory oversight responsibilities; (3) require boards to maintain a corporate culture that, among other things, emphasizes legal and regulatory compliance; and (4) prescribe how board self-assessments are conducted and documented.

Second, the Federal Reserve should withdraw its proposed guidance on the communication of supervisory findings. If certain boards are receiving too many matters requiring immediate attention ("MRIAs") and matters requiring attention ("MRAs"), the solution is not to drop the board as a recipient of the document. Instead, the agency should establish a procedural framework that helps the government better track the resolution of enforcement actions, including MRIAs and MRAs, and helps boards do even better at ensuring all MRIAs and MRAs are fully resolved. To implement this framework, the government should create and maintain a single database that, among other features and content, allows certain users to print a report of, at a minimum, all federal government enforcement actions (formal and informal) against a holding company and members of its enterprise, and the status of each such action.[7]

Third, the agency should modify its proposed rating system for large financial institutions to have separate ratings for the boards of directors and management. A consolidated score could mask instances where the board performs well, but senior management does not, and vice versa.

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[7] *See generally* Steven T. Mnuchin & Craig S. Phillips, U.S. Dep't of the Treasury, *A Financial System That Creates Economic Opportunities: Capital Markets* (Oct. 2017) ("Treasury Report"), at p. 45 ("Treasury recommends that federal and state financial regulators, along with their counterparts in self-regulatory organizations, work to centralize reporting of individuals and firms that have been subject to adjudicated disciplinary proceedings or criminal convictions, which can be searched easily and efficiently by the investing public free of charge."), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf; Mark Egan, Gregor Matvos & Amit Seru, *The Market for Financial Adviser Misconduct* (Sept. 2017) ("Seru Article"), *available at* https://ssrn.com/abstract=2739170, *Journal of Political Economy* (Forthcoming) (providing a large-scale study that documents the economy-wide extent of misconduct among financial advisers and the associated labor market consequences of misconduct; collecting related literature).

Moreover, in addition to setting higher expectations (the highest rating should not be "satisfactory"), the agency needs to threaten stiffer consequences for low governance and controls ratings. Given the extent of the enforcement records of certain large financial institutions, it is no longer reasonable to believe the threat of another civil monetary penalty order, for example, will motivate certain institutions to invest in the legal and compliance systems and personnel necessary for institutions of their size, complexity, and geographical reach.

COMMENTS

1. The federal government needs a new legal regime for the boards of large, complex holding companies that is designed to stop or minimize the misconduct. The current one no longer works well, to the extent it ever did.

The largest, complex financial institutions operating in the United States today are, or are part of, a financial holding company structure[8] (with a board of directors that has the ultimate responsibility to oversee the enterprise) or an intermediate holding company structure[9] (with a board of directors who may or may not have or share the ultimate responsibility to oversee the enterprise). As of September 30, 2017, there were 38 financial holding companies or intermediate holding companies in the United States with more than $50 billion in assets, of which four had more than $1.8 trillion in assets. Together, the companies had approximately $16.4 trillion in assets.[10]

These holding companies are larger and more complex than their predecessors. By way of example, Wells Fargo & Co., which is a financial holding company, grew from approximately $1.2 trillion to $1.9 trillion in assets between December 31, 2008 and December 31, 2016, with long-term debt and stockholder equity growing from approximately $316 billion to $455 billion during that period.[11] As a point of comparison, Citigroup was the largest bank in the United

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[8] The "bank holding company" structure is "[a] company that owns and/or controls one or more U.S. banks or one that owns, or has controlling interest in, one or more banks. A bank holding company may also own another bank holding company, which in turn owns or controls a bank." In 1999, the federal government created the "financial holding company" structure, which is basically a bank holding company structure through which entities may engage in non-banking financial activities such as securities underwriting. *See* 12 CFR §§ 225.81, 252.2(c), https://www.fedpartnership.gov/bank-life-cycle/grow-shareholder-value/bank-holding-companies and https://www.ffiec.gov/nicpubweb/content/help/institution%20type%20description.htm.

[9] In 2010, the federal government created the "intermediate holding company," which is the top-tier U.S. company that foreign banking organizations with $50 billion or more in U.S. non-branch/agency assets use to conduct business in the United States. *See* 12 CFR §§ 252.153, 252.2(gg).

[10] Federal Reserve, National Information Center, Holding Companies with Assets Greater Than $10 Billion, *available at* https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.

[11] Wells Fargo & Company 2016 Annual Report, at p. 38, *available at* https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2016-annual-report.pdf;

States in 1990 with assets around $230 billion, which is about $434 billion today adjusted for inflation.[12] Likewise, in 2012, the four most complex institutions each had more than 2,000 subsidiaries and two had more than 3,000 subsidiaries, while each of the seven most internationally active ones controlled subsidiaries in 40 or more countries. In 1990, only one firm exceeded 500 subsidiaries and only two firms controlled subsidiaries in 40 or more countries.[13]

Under U.S. law, there has long been a patchwork of state and federal statutes, regulations, rules, supervisory letters, legal decisions and settlements, and other sources of hard and soft law that govern the conduct of the boards for these large holding companies. While a full summary of the law is beyond the scope of this comment letter, below are brief overviews of some key aspects of this legal regime. Bottom line, this legal regime has not been sufficiently adjusted in recent years to address the radical transformation of the holding companies to which it applies, or the rising costs and longer delays associated with the federal agencies enforcing the law.[14]

A. Delaware law falls short.

Although most people think of New York as the banking capital of the United States, Delaware – from an incorporation perspective – is the banking capital of the United States. Today, most, if not all, of the largest holding companies are organized in Delaware as corporations. As the federal government is well-aware, Delaware law has not motivated certain large holding companies to invest in the legal and compliance systems and personnel necessary for institutions of their size, complexity, and geographical reach.

Delaware law, in many ways, treats corporations like JPMorgan Chase & Co. with approximately $2.6 trillion in assets the same way it treats a mom-and-pop ice cream shop in downtown Wilmington. For instance, the boards of Delaware corporations, regardless of their

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Wells Fargo & Company 2009 Annual Report, at p. 35, *available at* https://www.wellsfargohistory.com/download/annualreports/2009annualreport_wf.pdf.

[12] Noel Tichy & Ram Charan, *Citigroup Faces the World: An Interview with John Reed*, Harvard Business Review (Nov./Dec. 1990), *available at* https://hbr.org/1990/11/citicorp-faces-the-world-an-interview-with-john-reed. The website http://www.usinflationcalculator.com/ was used to calculate the adjustment for inflation.

[13] Dafna Avraham, Patricia Selvaggi & James Vickery, *A Structural View of U.S. Bank Holding Companies*, FRBNY Econ. Policy Rev. (July 2012), at p. 66, *available at* https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207avra.pdf.

[14] While not discussed herein, a body of law suggests bank boards of directors have a more demanding duty of care than other directors. The Federal Deposit Insurance Corporation ("FDIC"), as a receiver, has invoked this body of law against directors of failed banks and thrifts to address their fiduciary breaches. For more about these lawsuits, see https://www.fdic.gov/bank/individual/failed/pls/ and https://www.fdic.gov/about/freedom/plsa/index.html. *See also* Patricia A. McCoy, *The Notional Business Judgment Rule in Banking*, 44 Cath. U. L. Rev. 1031 (1995), *available at* http://scholarship.law.edu/cgi/viewcontent.cgi?article=1607&context=lawreview; Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 Case W. Res. L. Rev. 1 (1996), *available at* http://scholarlycommons.law.case.edu/cgi/viewcontent.cgi?article=2170&context=caselrev.

size and complexity, need have only one or more members (each, a human) and need not have any particular expertise.[15] Common sense suggests this approach makes no sense.

Moreover, Delaware law affords tremendous deference, through various statutes and legal doctrines, to boards. For example, Delaware law allows corporations to include a clause in their certificates of incorporation that eliminates or limits the personal liability of a director to the corporation or its stockholders for monetary damages stemming from certain breaches of fiduciary duty.[16] Citigroup Inc. and JPMorgan Chase & Co. have such a clause in their governance papers.[17] Other large holding companies no doubt have them too. Delaware also uses the business judgment rule, which (if certain criteria are met) requires judges, arbitrators, and juries applying Delaware law to not substitute their judgment for conscious business decisions of the board.[18] And with regard to a board's duty to monitor, the highest court in Delaware has said that adjudicators should assess director oversight liability only if (i) the directors failed to implement any reporting or information system or controls or (ii) having implemented those systems or controls, the directors consciously failed to monitor or oversee their operations.[19]

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[15] *See* Delaware Code Title 8. Corporations § 141(b). *See also* Delaware Code Title 8. Corporations § 141(a) ("(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

[16] *See* Delaware Code Title 8. Corporations § 102(b)(7) ("In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: … A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.").

[17] Restated Certificate of Incorporation of Citigroup, Inc., *available at* http://www.citigroup.com/citi/investor/data/citigroup_rci.pdf?ieNocache=923; JPMorgan Chase & Co. Restated Certificate of Incorporation, *available at* https://www.jpmorganchase.com/corporate/About-JPMC/document/certificate-of-amendment-to-certificate-of-incorporation.pdf.

[18] *See Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); with respect to the boards' duties of care, loyalty and good faith, *see, e.g.*, *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *In Re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006); *Schoon v. Smith*, 953 A.2d 196 (Del. 2008).

[19] *See Stone v. Ritter*, 911 A.2d 362, 370-71 (Del. 2006); *see also In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (establishing the basic duties of the board to monitor corporate acts); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009) (applying *Stone* and *Caremark* to dismiss an attempt to hold the Citigroup board liable for the firm's losses).

Of note, in December 2017, the Delaware Court of Chancery dismissed another attempt to hold the Citigroup board liable, stating "Here, the Plaintiffs, with admirable effort and the aid of records obtained under Section 220, produced a ponderous omnibus of a complaint. It describes red flags placed before the directors, dating back to the financial crisis of a decade ago as well as more recently, in connection with activities of Citigroup and its subsidiaries that led to large fines levied against the bank. The Complaint makes it reasonably conceivable that the

In sum, Delaware law leaves much to be desired as a tool for motivating the boards of systemically important financial institutions and others to demand better legal and compliance practices at their firms.[20]

B. Federal law falls short too.

Much like Delaware law, neither the letter nor enforcement of federal law has motivated certain large holding companies to make sufficient investments in legal and compliance.

Federal law sets no rules for how many hours a director must work to fulfill her or his duties, either by describing the role as full-time or regulating how many boards on which a director can serve at the same time.[21] Moreover, federal law has limited requirements regarding director qualifications. For instance, the Federal Reserve adopted rules pursuant to Dodd-Frank implementing risk committee requirements for certain large companies, including a requirement that the committee have at least one member with "experience in identifying, assessing, and managing risk exposures of large, complex firms."[22] In the same vein, with respect to board committees, federal law mostly permits the board to decide which committees it wants. While

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directors, despite these red flags, failed to take actions that may have avoided loss to the company. That is not the standard, however. To my mind, the allegations of the Complaint, if true, fail to demonstrate scienter. The Complaint does not make it reasonably conceivable that the directors acted in bad faith. Therefore, the Motion to Dismiss is granted." *See* Mem. Op., *Okla. Firefighters Pension & Ret. Sys. et al. v. Corbat et al.*, C.A. No. 12151-VCG, *available at* https://courts.delaware.gov/Opinions/Download.aspx?id=266760; *see generally* Arthur E. Wilmarth Jr., *Citigroup: A Case Study in Managerial and Regulatory Failures*, 47 IND. L. REV. 69, 119 (2013), *available at* http://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2234&context=faculty_publications.

[20] *See generally* Frank Partnoy, Delaware and Financial Risk (2017). The Corporate Contract in Changing Times (Forthcoming); San Diego Legal Studies Paper No. 17-280, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2958893.

[21] Federal law does prohibit certain directors from serving on certain boards at the same time. *See* 12 U.S.C. § 3203 ("If a depository institution or a depository holding company has total assets exceeding $2,500,000,000, a management official of such institution or any affiliate thereof may not serve as a management official of any other nonaffiliated depository institution or depository holding company having total assets exceeding $1,500,000,000 or as a management official of any affiliate of such other institution."); *see generally* Jeremy C. Kress, *Board to Death: How Busy Directors Could Cause the Next Financial Crisis*, 59 B.C. L. Rev. ___ (forthcoming 2018) ("Kress Article"), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2991142.

If institutions are finding it difficult to find individuals with sufficient skills, knowledge, experience, perspective, and time to serve as effective directors, such difficulty may suggest an underlying problem with the size, complexity, and geographical reach of the institutions (*i.e.*, the institutions have become too big to manage or control). The Federal Reserve has authority under Dodd Frank (including under Title 1 thereof) to address this problem, which it has been argued may be due to the availability of subsidized funding these institutions enjoy. On implicit subsidies, see Anat Admati, Testimony at Hearing on Examining the GAO Report on Expectations of Government Support for Bank Holding Companies, U.S. Senate, Subcommittee on Financial Institutions and Consumer Protection (July 31, 2014), *available at* https://www.banking.senate.gov/public/_cache/files/3e6b2c82-dce3-4fa1-a764-04fe9e447792/33A699FF535D59925B69836A6E068FD0.admatitestimonyficp73114.pdf.

[22] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 FR 17240, 17249 (Mar. 27, 2014), *available at* https://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf.

an audit committee is required, boards are not required by statute or rule to have a committee that focuses on legal and regulatory compliance.[23]

In addition, Dodd-Frank imposed, or sought to impose, new requirements for executive compensation, which boards must approve. While many provisions were directed to the U.S. Securities and Exchange Commission for rulemakings,[24] section 956 required the federal financial regulators to jointly issue regulations (1) prohibiting incentive-based payment arrangements that the agencies determine encourage inappropriate risks by covered financial institutions, either by providing excessive compensation or creating the possibility of material financial losses to the institution, and (2) requiring those institutions to disclose information concerning incentive-based compensation arrangements to the appropriate federal regulator. In June 2016, the agencies, including the Federal Reserve, issued a proposed rulemaking to implement section 956. The release cites a 2009 survey from a global group of major financial institutions showing that 98 percent of respondents "recognized the contribution of incentive-based compensation practices to the financial crisis."[25] The rulemaking remains unfinished.

Meanwhile, when directors engage in misconduct, it is difficult for federal agencies to remove them from the boardroom, especially publicly. As context here, the Federal Reserve cannot summarily remove directors. To remove directors (who undoubtedly will have well-paid, highly-capable defense lawyers fighting the agency every step of the way), the agency must make its case against the director and afford the director certain due process. In the case of a public removal, the agency must afford the director a hearing and be prepared to defend its decision on appeal.[26] This process (from investigation to settlement or investigation through appeal) could take considerable resources and years to complete, perhaps exceeding the amount

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[23] *See* Sarbanes-Oxley Act of 2002, 116 STAT. 746. Before SOX was enacted, the Federal Deposit Insurance Act, as implemented by part 363 of the FDIC's regulations, required all FDIC-insured depository institutions with total assets of $500 million or more to have board-level audit committees. *See* 12 CFR § 363.5.

[24] The status of the SEC rulemakings can be found at https://www.sec.gov/spotlight/dodd-frank.shtml#.

[25] Incentive-Based Compensation Arrangements, 81 FR 37670, 37674 & 37674 n. 17 (June 10, 2016), *available at* https://www.federalregister.gov/documents/2016/06/10/2016-11788/incentive-based-compensation-arrangements.

[26] *See* 12 U.S.C. §§ 1818(e) & (h). The removal standard has multiple prongs. First, the agency must show the director, directly or indirectly, (1) violated the law, (2) engaged or participated in any unsafe or unsound practice in connection with any insured depository institution or business institution, or (3) committed or engaged in any act, omission, or practice which constitutes a breach of his or her fiduciary duty. Next, the agency must show that, due to the violation, practice, or breach, (1) the institution suffered or will probably suffer financial loss or other damage; (2) the interests of the institution's depositors have been or could be prejudiced; or (3) the director received financial gain or other benefit by reason of such violation, practice, or breach. And then, the agency must show that the violation, practice, or breach (1) involves personal dishonesty on the part of the director or (2) demonstrates willful or continuing disregard by such party for the safety or soundness of the institution.

of time a director has left in his or her term.[27] As context, the independent directors of Wells Fargo & Co. board have an average tenure of six years.[28]

Simply put, absent making changes to the law, it appears unreasonable at this point to assume the law will motivate the big bank boards to do better at legal and compliance.

2. The Federal Reserve and other agencies should work together to strengthen the law governing the boards of the largest holding companies operating in the United States. Where one sits often affects what one sees.

The federal financial regulators and other interested agencies need to collectively develop and enforce a legal regime for the boards of holding companies that will stop or sufficiently minimize the misconduct. There appears to be few existing vehicles (*e.g.*, task forces, working groups, interagency bodies) at or through which the Federal Reserve could raise the issue and ask questions, and secure input from other federal agencies. Current options include the Federal Financial Institutions Examination Council ("FFIEC") and the Financial Stability Oversight Council ("FSOC").

In 1979, Congress established and empowered a formal interagency body called the FFIEC to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions.[29] The Consumer Financial Protection Bureau, FDIC, Federal Reserve, National Credit Union Administration, OCC, and a representative state regulator are voting members of the FFIEC. The chairmanship of the FFIEC rotates among the members.[30]

In 2010, Dodd-Frank established FSOC to, *inter alia*, (1) identify risks to the financial stability of the United States that could arise from ongoing activities of large, interconnected bank holding companies or non-bank financial companies and (2) respond to emerging threats to the stability of the U.S. financial system. FSOC's voting members include the Secretary of the Treasury (who serves as FSOC's chair), the Chair of the Federal Reserve Board, the leaders of

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[27] In pointing out the difficulty of removing board members, the scholars are not suggesting the Federal Reserve should not pursue and secure such removals (the agency should, especially in egregious cases). Rather, they are describing an area of law and policy that needs revisiting if the government's goal is for the agency to remove directors efficiently and publicly.

[28] Antoine Gara, *Wells Fargo's Attempt At Redemption: Scandal-Plagued Lender Names Former Fed Official As Chair*, Fortune (Aug. 16, 2017), *available at* https://www.forbes.com/sites/antoinegara/2017/08/16/wells-fargos-attempt-at-redemption-scandal-plagued-lender-names-former-fed-official-as-chair/#6065302c8a5a.

[29] Congress established the FFIEC in 1979 pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, Public Law 95-630.

[30] 12 U.S.C. § 3303.

the other federal financial regulators, and one independent member with insurance expertise.[31] FSOC's duties include, for instance, (1) monitoring for potential threats to U.S. financial stability; (2) monitoring regulatory proposals and developments and making recommendations to Congress to improve U.S. financial markets; (3) facilitating information sharing and coordination among FSOC members and other federal and state agencies regarding domestic policy development, rulemakings, and enforcement actions; (4) identifying gaps in regulation that could pose risks to U.S. financial stability; and (5) recommending to member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies. To complete this work, FSOC may appoint people to "such special advisory, technical, or professional committees as may be useful in carrying out the functions of the Council."[32]

Rather than continuing with its proposals as written, the Federal Reserve should seek input from all the other federal financial regulators and interested agencies, including the U.S. Department of Justice, and reevaluate the proposals with the benefit of cross-agency input. Because where one sits often affects what one sees, each agency probably will have unique insights into the strengths and weaknesses of today's holding company boards.[33] Should the Federal Reserve not want to seek input through FFIEC (which has fewer agencies and currently is led by the FDIC Chair) or FSOC (which includes more agencies and is led by the Treasury Secretary), the agency could do one-on-one outreach to each agency and office.[34] Regardless of how it seeks input, the Federal Reserve should share, as appropriate, with the agencies "the results of" its "multi-year review … of practices of boards of directors, particularly at the largest banking organizations" and engage the other agencies on "the factors that make boards effective, the challenges boards face, and how boards influence the safety and soundness of their firms and promote compliance with laws and regulations."[35]

3. Assuming the agency wants to move ahead now (without seeking more input from other agencies), the Federal Reserve should not adopt the Proposed Guidance on Supervisory Expectation for Boards of Directors as written.

The Federal Reserve casts its proposed guidance as a necessary realignment and clarification of the agency's supervisory expectations for the boards of directors at domestic bank and financial holding companies with total consolidated assets of $50 billion or more,

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[31] *See* 12 U.S.C. §§ 5321, 5322.

[32] *See* 12 U.S.C. §§ 5321, 5322.

[33] It is not enough, as the Federal Reserve suggested in the proposed guidance, to have other banking agencies comment on certain parts of these proposals. *See* Proposed Guidance, 82 FR 37219, 37220.

[34] The Federal Reserve also should consider creating cross-agency task forces or working groups on various related issues such as one focused on how holding company boards can ensure all subsidiary-level MRAs or equivalents become part of the holding company board's tracking systems.

[35] Proposed Guidance, 82 FR 37219, 37219.

among other types of institutions.[36] While there is no disagreement that expectations need to be reset, the scholars strongly disagree that the proposed guidance is a step in the right direction.

As discussed below, the agency should amend its proposed text for the supervisory guidance on board of directors' effectiveness to (1) incorporate expected outcomes for the boards; (2) require boards to select directors who have the time necessary to do their jobs well, including their legal and regulatory oversight responsibilities; (3) require boards to maintain a corporate culture that, among other things, emphasizes legal and regulatory compliance; and (4) prescribe how board self-assessments are conducted and documented. In addition, the Federal Reserve should withdraw its proposed guidance on the communication of supervisory findings and replace it with a procedural framework that helps the government and boards better track enforcement actions, including MRIAs and MRAs.

A. The proposed text for the supervisory guidance on board of directors' effectiveness sets essentially no expected outcomes for directors, nor demands boards select directors who have the time necessary to do their jobs well.

The proposed text identifies the following five key tasks that boards must do: "(1) Set clear, aligned, and consistent direction regarding the firm's strategy and risk tolerance, (2) actively manage information flow and board discussions, (3) hold senior management accountable, (4) support the independence and stature of independent risk management and internal audit, and (5) maintain a capable board composition and governance structure." The Federal Reserve drops a footnote to clarify that independent risk management, in the agency's view, includes compliance.[37] Nowhere in the proposed text does the Federal Reserve (1) set specific outcomes for the boards to achieve and maintain or (2) demand that boards select directors who have the time necessary to do their jobs well, including their legal and regulatory oversight responsibilities.

The Federal Reserve should incorporate into the proposed text specific outcomes for boards to achieve and maintain. The failure to include such expected outcomes in the proposed text will produce different results at and for the firms, including potentially inflated ratings for the firms. This is both common sense and proven in other settings where group or individual performance is evaluated. For example, for a reason, professors do not grade students solely based on whether they did the assigned reading. If they did, students who completed the task (*i.e.*, read the assigned cases) would receive high marks regardless of whether they understood the materials and could apply them.

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[36] Proposed Guidance, 82 FR 37219, 37220.

[37] Proposed Guidance, 82 FR 37219, 37220 & 37220 n.5.

By way of example, subject directors should be expected to ensure that institutions and persons within the bank holding company structure comply with applicable laws, regulations, and rules. Here, such compliance should mean that, at a minimum, the directors ensure these institutions and persons avoid any non-trivial violations, which include violations that cause harm to customers, clients, or shareholders, or are the same or similar to a prior violation by the same institution or person. For purposes of evaluating whether directors have met this expectation, the Federal Reserve should consider, at a minimum, any allegations by federal and state agencies against institutions and persons within the bank holding company structure that a competent court or jury has not fully rejected.

Relatedly, the Federal Reserve should amend the proposed text to require boards to select directors who have the time necessary to do their jobs well. Currently, notwithstanding research suggesting that overextended board directors could spark the next financial crisis, and the government's repeated use of its limited resources to address misconduct stemming from board failures, the proposed text merely requires boards to have a process for identifying and selecting director nominees that considers the potential nominee's availability.[38] Moreover, the Federal Reserve should not revise or rescind its expectation that boards "[m]aintain a corporate culture that emphasizes the importance of compliance with laws and regulations and consumer protection, as well as the avoidance of conflicts of interest and the management of reputational and legal risks."[39] Since the Federal Reserve placed this expectation on boards about five years ago, the private sector has developed better tools for companies to gather and monitor data on corporate culture (*e.g.*, through employee feedback, hotline calls, management reviews, and site visits), thus making it even easier for firms to comply.[40]

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[38] Proposed Guidance, 82 FR 37219, 37226. *See, e.g.*, Kress Article, at p. 13 ("Director workloads have increased substantially since the early 2000s. Directors now devote, on average, more than 20 hours per month to each board on which they serve. Time commitments are even higher for board chairs, lead independent directors, and directors who chair board committees. Directors with many professional engagements, therefore, might lack time to carefully review reports, assess strategy and risk, and attend board and committee meetings for all of the companies with which they are affiliated."), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2991142; *see generally* Kara M. Stein, *Mutualism: Reimagining the Role of Shareholders in Modern Corporate Governance* (Feb. 13, 2018) (discussing how, in modern corporate governance, the concept of mutualism may help people analyze the path forward for corporations, shareholders and the larger corporate ecosystem; addressing cyberthreats and board composition, among other topics), *available at* https://www.sec.gov/news/speech/speech-stein-021318.

[39] *See* Proposed Guidance, 82 FR 37219, 37221.

[40] Federal Reserve, Consolidated Supervision Framework for Large Financial Institutions, SR 12-17 (Dec. 17, 2012), *available at* https://www.federalreserve.gov/supervisionreg/srletters/sr1217.htm); William Dudley, *Reforming Culture for the Long Term* (Mar. 21, 2017) ("Since the beginning of our work on culture, my colleagues and I have recognized that measurement is indispensable to improving bank culture. We have not been alone in this view."), *available at* https://www.newyorkfed.org/newsevents/speeches/2017/dud170321.

B. The proposed text for the supervisory guidance on board of directors' effectiveness should be amended to prescribe how board self-assessments are conducted and documented.

Board self-evaluations have been good practice for years now. The New York Stock Exchange ("NYSE") requires the board of directors of all companies listed on the NYSE to conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.[41] Likewise, as mentioned earlier, the OCC requires the board of directors of certain large institutions to conduct an annual self-assessment, albeit a limited one.

While the Federal Reserve should require these self-assessments no less than annually, the Federal Reserve should not rely on the boards' self-evaluation as the "primary" basis for its supervisory evaluation of board effectiveness.[42] Professors (not students) grade student papers because the professors do not have a personal stake in the grade. Regulators should assess regulated persons themselves for the same reason. This is especially true where lawyers will review and potentially adjust the self-evaluation before it is produced to the Federal Reserve.

In requiring these self-assessments, the Federal Reserve should consider randomly assigning vendors to each board, subject to a conflict check, from a list of vendors that the Federal Reserve has vetted, especially for actual or potential conflicts. The Federal Reserve also should require the self-assessment to have sufficient detail for the Federal Reserve to evaluate the performance of the entire board, each committee, and each director.

In addition, to identify questions for these self-evaluations, the Federal Reserve should carefully review, among other resources,[43] the Shearman & Sterling LLP report regarding the Wells Fargo & Co. board and ask itself: What questions should an evaluator ask to pull together information that may help the Federal Reserve and the bank prevent the next big scandal? For example, the Shearman report documents the alarming scope of the failures by Enrique Hernandez, Jr., who oversaw the Wells Fargo & Co.'s Risk Committee in 2013 when the *Los Angeles Times* reported the story on Wells Fargo's sales practices and remains on the Wells Fargo board. In the Federal Reserve's view, what questions should Wells Fargo have asked during its board self-evaluation process to determine whether Hernandez was (and remains) fit for the job?[44]

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[41] NYSE Rule 303A.09 ("Annual performance evaluation of the board. The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.").

[42] Proposed Guidance, 82 FR 37219, 37223.

[43] *See, e.g.,* Kress Article, at pp. 22-25 (analyzing how director over-commitment inhibited the ability of the Wells Fargo board to diagnose and correct the sales practice problems).

[44] Shearman & Sterling LLP, *Independent Directors of the Board of Wells Fargo & Company Sales Practices Investigation Report* (Apr. 10, 2017), at p. 14 ("Finally, until as late as 2015, even as sales practices were labeled a "high risk" in materials provided to the Risk Committee of the Board, there was a general perception within Wells Fargo's control functions that sales practice abuses were a problem of relatively modest significance, the equivalent of a tolerable number of minor infractions or victimless crimes. This underreaction to sales practice issues resulted

C. The proposed text for communications of supervisory findings would make it less likely that boards will stop the next 'Wells Fargo'. It should be withdrawn and replaced with a procedural framework that helps the government and boards better track enforcement actions, including MRIAs and MRAs.

Under existing procedures, the Federal Reserve presents MRIAs and MRAs to the boards of directors so that the board may ensure that senior management addresses the issues identified in the supervisory findings.[45] Now, the Federal Reserve proposes directing MRIAs and MRAs to an institution's board for corrective action under only two scenarios. First, the agency would direct these matters to the board where "significant weaknesses in an institution's board governance structure and practices are identified," including "instances where the board does not provide effective oversight of senior management or fails to hold senior management accountable for fulfilling its responsibilities". Second, the agency would direct these matters to the board or an executive-level committee of the board where "senior management fails to take or ensure appropriate action is taken to correct material deficiencies or weaknesses".[46] Clearly, this proposal would reduce information flow to the board.

For context here, according to the agency, "MRIAs arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires a supervised institution to address immediately and include: (1) Matters that have the potential to pose significant risk to the safety and soundness of the institution; (2) matters that represent significant noncompliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the institution; and (4) matters that have the potential to cause significant consumer harm." In contrast, "MRAs constitute matters that are important and that the Federal Reserve is expecting a supervised institution to address over a reasonable period of time, but the timing need not be 'immediate.' While issues giving rise to MRAs must be addressed to ensure the institution operates in a safe-and-sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs."[47] MRIAs and MRAs are considered "informal" enforcement actions because the agency's authority to impose them is based on

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in part from the incorrect belief, extending well into 2015, that improper practices did not cause any "customer harm"; and "customer harm" itself was narrowly construed to mean only financial harm such as fees and penalties."), *available at* https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf.

[45] Proposed Guidance, 82 FR 37219, 37222 (citing SR letter 13-13/CA letter 13-10, "Supervisory Considerations for the Communication of Supervisory Findings" at https://www.federalreserve.gov/supervisionreg/srletters/sr1313.htm).

[46] Proposed Guidance, 82 FR 37219, 37226-37227.

[47] Proposed Guidance, 82 FR 37219, 37226.

various Federal Reserve Supervisory and Regulation Letters, which describe the agency's expectations and objectives as the key supervisor for large, complex banking companies.[48]

As further context, the Federal Reserve does not release MRIAs and MRAs, nor does it report the number of such actions that each institution has. That said, in 2015, the staff of the Federal Reserve Bank of New York released summary data on the informal enforcement actions that 12 systemically important financial firms received between January 2011 and November 2014. In total, they received 1,340 MRAs and 160 MRIAs, among other types of actions.[49] As the staff explained, "It is typical for a banking organization to have many outstanding MRAs and MRIAs at any given time, reflecting the outcomes of the range of supervisory activities undertaken by the firm-focused supervisory team and other Federal Reserve supervisory staff." "If the firm fails to address sufficiently the deficiency identified in the MRA or MRIA, then the matter can be escalated into more severe enforcement actions …".[50]

In its proposal, the Federal Reserve summarily argues this change of protocol "would facilitate the execution of boards' core responsibilities," forgoing any discussion of the problems or potential problems the new protocol creates.[51] The biggest problem (potentially) with the proposed protocol is that it places the burden on Federal Reserve staff and senior management of the company to determine when the board needs to be notified.[52] Even assuming *arguendo* that the staff would always have the information needed to make these calls (which is highly doubtful, notwithstanding staff efforts to collect such information), placing the burden on staff has numerous, unacceptable drawbacks. For example, the boards of these financial institutions (or their defense counsel) may disclaim responsibility for any or some MRIAs or MRAs that are not directed at them. Similarly, even assuming *arguendo* that senior management would always have the information needed to make these calls, senior management may be conflicted where

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[48] *See* Federal Reserve Bank of New York, *Supervising Large, Complex Financial Institutions: What Do Supervisors Do?*, Staff Report No. 729 (May 2015), p. 29, *available at* https://www.newyorkfed.org/research/staff_reports/sr729 ("FRBNY Staff Report No. 729").

[49] This data appears to include 12 firms, including three non-bank financial institutions that were not under the agency's supervision the entire period (January 2011 to November 2014). FRBNY Staff Report No. 729, at p.8.

[50] FRBNY Staff Report No. 729, at p. 30.

[51] Proposed Guidance, 82 FR 37219, 37220.

[52] On January 11, 2018, the Federal Reserve issued a proposed supervisory guidance addressing the management of business lines and independent risk management and controls for large financial institutions. 83 FR 1351. Therein, the agency stated the following: "Senior management is responsible for providing timely, useful, and accurate information to the board. Senior management should also be responsive to direction from the board and to the board's informational needs. Further, senior management is responsible for ensuring resolution of risk management issues (including those identified by the firm and outstanding supervisory matters), escalating issues to the board, and communicating issues internally when appropriate. Senior management should regularly report to the board on responses to, and remediation of, material audit and supervisory findings, risk management and control deficiencies, material compliance issues (including those related to consumer protection), and the outcomes of risk reviews which may result in remedial actions." 83 FR 1351, 1357.

the supervisory action involves a problem the senior managers created. In any event, it is not wise policy to handicap the board's own assessment of which issues are especially important for the institution to address and obstruct the board's ability to hold managers accountable.

Indeed, there is no question that this change in protocol could lead to serious harm. In April 2017, the OCC's Office of Enterprise Governance and the Ombudsman issued a report documenting various lessons learned from supervising Wells Fargo Bank, N.A. The report states that the OCC failed at times to issue MRAs to the entire Wells Fargo Bank N.A. board of directors, on which (at varying points during the relevant period) former Wells CEO John Stumpf, current Wells CEO Tim Sloan, and former senior executive Carrier Tolstedt sat.[53] The MRAs, as the OCC points out, contained information that could have helped prevent or stop customer harm. For example, the OCC issued an MRA dated March 22, 2010 requiring the implementation of an enterprise-wide complaint management system; the OCC did not issue the MRA to the board.[54] Under the Federal Reserve's proposed litmus test ("significant weaknesses in [the] institution's board governance structure and practices"), the Federal Reserve would not issue such MRAs to the holding company boards, thus making it more difficult for the board to help prevent or stop customer harm.

Instead of this proposal, the Federal Reserve should establish a procedural framework that will (a) help the government better track the resolution of enforcement actions, including MRIAs and MRAs, and (b) help boards do even better at ensuring all MRIAs and MRAs are fully resolved. The procedural framework should (a) require the banking agencies to direct every MRIA or MRA to the board of directors and (b) require the board of directors to establish and maintain specific policies and procedures that require the board (either directly or through an authorized committee such as the audit or risk committee) to review the MRIA or MRA, communicate with senior management about the MRIA or MRA, obtain a written plan of action from senior management regarding management's response to the MRIA or MRA, approve that plan of action, and present a report to the full board of directors after the plan of action has been completed. The report to the full board must inform the directors of the results of the approved plan of action and whether the MRIA or MRA has been fully resolved and removed from the

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[53] *See* OCC, Office of Enterprise Governance and the Ombudsman, *Lessons Learned Review of Supervision of Sales Practices at Wells Fargo* (Apr. 19, 2017), at pp. 10-11, *available at* https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-wells-fargo-supervision-lessons-learned-41917.pdf ("OCC Report"). The report states that the OCC did not send certain MRAs to the board or a board committee. It does not state that the OCC did not send certain MRAs to a board member. At various points during the relevant period, Ms. Tolstedt and Mr. Stumpf sat on the Wells Fargo Bank, N.A. board. It is unclear from the report whether one or both had stepped down from the bank board before s/he received the MRAs.

Board member names can be found in the signature blocks of various OCC settlements. *See, e.g.*, https://www.occ.gov/static/enforcement-actions/ea2011-174.pdf; https://www.occ.gov/static/enforcement-actions/ea2013-132.pdf; https://www.occ.gov/static/enforcement-actions/ea2015-125.pdf; https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-106a.pdf.

[54] OCC Report, at p. 10.

agenda of the regulatory agency. If the MRIA or MRA has not been fully resolved after management has completed the approved plan of action, the board (or an authorized committee) must start a new procedure to resolve the MRIA or MRA by following the foregoing steps.

To implement this framework, the government should create and maintain a database of, at a minimum, all federal government enforcement actions (formal and informal) against holding companies and members of their enterprise, and the status of each such action. The government could make certain features and content of the database accessible to the public (*e.g.*, a printable list of public actions) and other features and content accessible only to the government, certain parts of the government, and/or the regulated entity (*e.g.*, a printable list of all public and non-public enforcement actions, the persons at the company primarily responsible for addressing the issues presented by the enforcement actions, and the steps the company has taken and will take to address those issues).

Such a database is long overdue.[55] As various government reports have documented, the Federal Reserve and peer agencies appear to struggle with tracking their enforcement actions from examination or investigation through resolution.[56] Moreover, while certain agencies have long stated they consider the enforcement records of an institution when deciding whether to charge an institution or how to sanction an institution,[57] and some agencies or agency personnel

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[55] *See generally* Treasury Report, at p. 45 ("Treasury recommends that federal and state financial regulators, along with their counterparts in self-regulatory organizations, work to centralize reporting of individuals and firms that have been subject to adjudicated disciplinary proceedings or criminal convictions, which can be searched easily and efficiently by the investing public free of charge."); Seru Article, at p. 2 ("While it is clear that egregious fraud does occur in the financial industry, the extent of misconduct in the industry as a whole has not been systematically documented.").

[56] *See* OCC Report, at pp. 10-11. *See also* Office of Inspector General, *The Board Can Improve the Effectiveness of Continuous Monitoring as a Supervisory Tool* (2017-SR-B-005) (Mar. 29, 2017), at pp. 5-6 ("We learned that institutions provide Reserve Banks with voluminous documentation for continuous monitoring on an ongoing basis. Some of the documents include board committee reporting packages …. During our interviews, we heard that examiners do not have sufficient time to review all this information and that the teams may not have analyzed all of the information prior to it being uploaded into the various repositories … We also learned that the approach to storing documentation on continuous monitoring activities can vary by supervisory teams or individual examiners. For example, when individual examiners upload documents to the various databases, two examiners may tag the same document with different areas of supervisory focus, which could affect whether and how quickly that information can be retrieved in the future."), *available at* https://oig.federalreserve.gov/reports/board-continuous-monitoring-effectiveness-mar2017.htm.

[57] *See*, *e.g.*, U.S. Department of Justice, U.S. Attorneys' Manual, Title 9-28.600, Principles of Federal Prosecution of Business Organizations, The Corporation's Past History ("General Principle: Prosecutors may consider a corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it, in determining whether to bring criminal charges and how best to resolve cases. Comment: A corporation, like a natural person, is expected to learn from its mistakes. A history of similar misconduct may be probative of a corporate culture that encouraged, or at least condoned, such misdeeds, regardless of any compliance programs. Criminal prosecution of a corporation may be particularly appropriate where the corporation previously had been subject to non-criminal guidance, warnings, or sanctions, or previous criminal charges, and it either had not taken adequate action to prevent future unlawful conduct or had continued to engage in the misconduct in spite of the

no doubt take such information into account, the reality is that agencies use imperfect methods and tools to piece together some or all of institution's enforcement record.

In short, the Federal Reserve's proposal to reduce the number of MRIAs and MRAs directed to the board is upside down. The agency should be stressing (i) the importance of robust information flow to the board of directors, who cannot exercise proper oversight if they are in the dark about the outstanding MRIAs and MRAs, and (ii) better tracking by the agency and regulated entities of enforcement actions. Should the Federal Reserve ultimately disagree, at a minimum, it should incorporate language into the "Matters Referred to the Board of Directors" section of its proposal that the agency's new protocol does not reduce the risk management and compliance oversight responsibilities of the boards of directors.

4. Assuming the agency wants to move ahead now (without seeking more input from other agencies), the Federal Reserve should not adopt its new rating system for large financial institutions as written.

The Federal Reserve has used the same rating system since 2004 to communicate its supervisory assessment of bank holding companies regardless of their asset size, complexity or systemic importance.[58] The agency proposes a new rating system for evaluating large financial institutions (the large financial institution, or "LFI", rating system) given the systemic risks they pose and the changes since 2004 to the Federal Reserve's expectations and oversight of those firms.[59] The Federal Reserve proposes to assign initial ratings during 2018.[60]

If this proposal goes into effect, the LFI ratings will be assigned and communicated to firms at least annually. The ratings will have the following three components: (1) capital planning and positions; (2) liquidity risk management and positions; and (3) governance and controls. For each component, the firm will receive either a "Satisfactory," "Satisfactory Watch," "Deficient-1" or "Deficient-2" rating. For purposes of the governance and controls component, each category has the following meaning:

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warnings or enforcement actions taken against it. The corporate structure itself (e.g., the creation or existence of subsidiaries or operating divisions) is not dispositive in this analysis, and enforcement actions taken against the corporation or any of its divisions, subsidiaries, and affiliates may be considered, if germane."), *available at* https://www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations.

[58] LFI Ratings Rulemaking, 82 FR 39049, 39050.

[59] LFI Ratings Rulemaking, 82 FR 39049, 39050.

[60] LFI Ratings Rulemaking, 82 FR 39049, 39049.

Governance and Controls Ratings[61]	
Satisfactory	"A firm's governance and control practices are considered sound and broadly meet supervisory expectations." "Although a firm rated 'Satisfactory' may have supervisory issues requiring corrective action, the firm is effectively mitigating the issues or the Federal Reserve has deemed the issues as unlikely to present a threat to the firm's ability to maintain safe and sound operations."
Satisfactory Watch	The rating "indicates that governance and controls are generally considered sound; however certain supervisory issues are sufficiently material that, if not resolved by the firm in a timely manner during the normal course of business, would put the firm's prospects for remaining safe and sound through a range of conditions at risk."
Deficient-1	"Although a firm's current condition is not considered to be materially threatened, there are deficiencies in a firm's governance or controls that put its prospects for remaining safe and sound through a range of conditions at significant risk. The firm's practices and capabilities do not meet supervisory expectations, and deficiencies limit its ability to align strategic business objectives with the firm's risk tolerance and risk management capabilities; maintain strong and independent risk management and control functions, including internal audit; promote compliance with laws and regulations; and/or otherwise provide for the firm's ongoing resiliency through a range of conditions."
Deficient-2	"Deficiencies in a firm's governance or controls present a material threat to its safety and soundness, or have already put the firm in an unsafe and unsound condition. Its practices and capabilities fall well short of supervisory expectations, and are insufficient to align strategic business objectives with the firm's risk tolerance and risk management capabilities; maintain strong and independent risk management and control functions, including internal audit; promote compliance with laws and regulations; and/or otherwise provide for the firm's ongoing resiliency."

Federal law grants privileges to well managed financial institutions.[62] For example, to even register as a financial holding company, the holding company, as well as all subsidiary depository institutions thereof, must be well managed and well capitalized, among other requirements.[63] Under the proposed LFI rating system, a firm can be rated "Satisfactory" or "Satisfactory Watch" for each of its three component ratings to be considered "well managed" for the purpose of these privileges.

As proposed, the third component (governance and controls) will evaluate (1) the effectiveness of the firm's board, (2) the firm's management of core business lines and independent risk management and controls, and (3) (for domestic LISCC firms) the firm's

[61] LFI Ratings Rulemaking, 82 FR 39049, 39062.

[62] LFI Ratings Rulemaking, 82 FR 39049, 39052 & 39052 n.16 (citing "12 U.S.C. 1841 et. seq. and 12 U.S.C. 1461 et. seq. See, e.g., 12 CFR 225.4(b)(6), 225.14, 225.22(a), 225.23, 225.85, and 225.86; 12 CFR 211.9(b), 211.10(a)(14), and 211.34; and 12 CFR 223.41.").

[63] *See, e.g.*, Electronic Applications and Applications Filing Information, Financial Holding Company Election, https://www.federalreserve.gov/supervisionreg/afi/fhcfilings.htm.

recovery planning. The Federal Reserve plans to use the five key attributes (or tasks) set forth in the Proposed Supervisory Expectation for Boards of Directors to evaluate board effectiveness for purposes of this rating. According to the agency, if a firm receives a Deficient-1 rating for governance and controls, there is a strong presumption the Federal Reserve will take informal or formal enforcement action against the firm and the Federal Reserve could use the rating as a basis for denying the firm's requests to engage in new or expansionary activities. If the firm receives a Deficient-2 rating, there is a strong presumption the agency will take a formal enforcement action against the firm and the agency would be "extremely unlikely" to approve any proposals by the firm to engage in new or expansionary activities.[64]

A. The Federal Reserve should not combine the ratings for the board and management.

The Federal Reserve should create separate ratings for the boards of directors and for management. Separating ratings should help the Federal Reserve drill down on where strengths and weaknesses exist at an institution. A consolidated score can mask failures. For instance, management could be managing the core business lines well while the board of directors is failing in one or more aspects of its job, or vice versa. In addition, separating ratings should help the agency identify patterns amongst the institutions with higher or lower ratings for the board.

B. The Federal Reserve needs to set higher expectations and threaten stiffer consequences to motivate the holding companies, including their boards, to do even better at legal and compliance.

The Federal Reserve, one could argue, has low expectations for the boards of institutions that are holding approximately $16.4 trillion in assets.[65] To begin with, the rating system the agency uses tops out at "satisfactory" (not outstanding, just satisfactory), thereby suggesting none of the subject firms has, or is likely to have, outstanding governance and controls practices. Likewise, the Federal Reserve twice casually mentions the board's duty to inquire into "material or persistent" problems at the institution.[66] As mentioned earlier, agency staff described it as "typical" that banks have "many outstanding MRAs and MRIAs at any given time."[67] And then, the Federal Reserve's many public orders against the same institutions speak for themselves.[68]

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[64] LFI Ratings Rulemaking, 82 FR 39049, 39062.

[65] *See* Federal Reserve, National Information Center, Holding Companies with Assets Greater Than $10 Billion, *available at* https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.

[66] Proposed Guidance, 82 FR 37219, 37225-37226.

[67] FRBNY Staff Report No. 729, at p. 30.

[68] Without endorsing the accuracy or completeness of this work, please see Philip Mattera's enforcement record summaries at http://www.corp-research.org/corporaterapsheets.

Regardless of whether its current expectations are low or high, the Federal Reserve needs to raise them to address the radical transformation of the largest holding companies in recent decades, as well as the new legal environment in which the Federal Reserve attempts to enforce the law. For example, the Federal Reserve should revise its menu of ratings to include an outstanding category, thus signaling that the goal is for regulated firms to have no or minimal supervisory issues requiring corrective action. In addition, the agency should revise the potential consequences descriptions in each rating level to explain whether and how an institution's prior non-compliance issues may affect the agency's decision to bring an informal or formal enforcement action against the institution. Presumably, it should be automatic that the agency brings some kind of action if the firm has ongoing, repeated failures.

Consistent with raising its expectations, the Federal Reserve must threaten and enforce stiffer consequences such as breaking up the institution or restricting its growth. The government-wide enforcement records of certain institutions, which are lengthy and filled with serious allegations and admissions, suggest that threatening yet another downgrade, enforcement action, or denial of new or expansionary activities will not convince certain firms to invest in the legal and compliance systems and personnel necessary for institutions of their size, complexity, and geographical reach. This is especially true where the Federal Reserve may take years to issue an action (informal or formal) or may not demand that the institution corrects all deficiencies before the next examination. Tougher consequences would signal that the agency will no longer tolerate systemically important financial institutions, among others, that harm the U.S. financial system, customers, or American taxpayers because they chose after repeated warnings and sanctions to not make sufficient investments in legal and compliance.[69]

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[69] While it was a step in the right direction for the Federal Reserve to restrict the growth of Wells Fargo until it sufficiently improves its governance and controls, the recent enforcement action against Wells Fargo and the letters addressed to the Board of Directors and Messrs. Stephen Sanger and John Stumpf were long overdue and (to many reasonable minds) inadequate. Even assuming *arguendo* that the agency decided not to take stronger enforcement actions against Wells Fargo because the agency wanted to encourage its future cooperation, the desire to encourage institutional cooperation does not explain why the agency failed to issue enforcement orders against any current or former executives or directors of Wells Fargo. It is difficult to understand why such individual enforcement orders by the Federal Reserve or another agency (or both) would not be issued at some point, given the well-documented misconduct at Wells Fargo, particularly when enforcement orders are routinely imposed in comparable circumstances against officers and directors of small and mid-sized banks. If the Federal Reserve believes that the federal government needs to revisit the law and policy governing the appropriate enforcement tools for the boards (and executives) of large, complex financial institutions, the agency should raise its concerns candidly with Congress or through notice-and-comment rulemaking. *See* the enforcement action and letters at https://www.federalreserve.gov/newsevents/pressreleases/enforcement20180202a.htm; Lawrence H. Summers, *Wells Fargo's board members are getting off too easy*, Washington Post (Feb. 6, 2018), *available at* https://www.washingtonpost.com/news/wonk/wp/2018/02/06/lawrence-summers-wells-fargos-board-members-are-getting-off-too-easy/?utm_term=.0c67a5a767e8.

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Thank you again for the opportunity to comment. I have copied on this letter a non-exclusive list of 15 other federal agencies and offices that, in the last decade alone, have entered into a large number of settlements with one or more holding companies or related entities for criminal, civil, or regulatory misconduct. To the extent that the Federal Reserve has not already consulted the leaders of those agencies and offices regarding its proposals, the Federal Reserve is strongly encouraged to make a specific request for input from each one.

Please do not hesitate to contact me or the scholars listed below with questions regarding these comments.

Sincerely,

Kristen A. Hutchens, Esq.

Business, Legal, and Public Policy Scholars	
Name	**School/Title**
Anat R. Admati	Stanford University, Graduate School of Business George G.C. Parker Professor of Finance and Economics
Peter Conti-Brown	The Wharton School of the University of Pennsylvania Assistant Professor of Legal Studies and Business Ethics
John Crawford	UC Hastings College of the Law Professor of Law
Robert Hockett	Cornell Law School Edward Cornell Professor of Law
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U.S. Department of Justice
Attorney General Jeff Sessions
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Secretary R. Alexander Acosta
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