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Proposed Guidance on Supervisory Expectations for Boards of Directors

October 10, 2017

Ms. Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
via http://www.regulations.gov
regs.comments@federalreserve.gov

Dear Ms. Misback:

The National Association of Corporate Directors (NACD) appreciates the opportunity to comment on recently proposed guidance on supervisory expectations for the boards of directors of institutions overseen by the Board of Governors of the Federal Reserve System (the Federal Reserve Board, or FRB). The proposed guidance seeks to clarify supervisory expectations for boards versus for senior management, and offers advice on board effectiveness to be implemented in the supervision of larger institutions.

NACD fully supports this initiative, one which clearly aligns with the FRB's mission to promote the "safety and soundness" of the financial institutions under its watch. We believe that by issuing board effectiveness guidance, the FRB can advance this worthy goal. Yet, we offer caution about the risk of being too prescriptive in defining board effectiveness and inadvertently creating another compliance mandate.

NACD, founded in 1977 as an association dedicated to director education, knows from our 40 years of experience that boards of directors can make a vital difference in the health of the enterprises they serve—including financial institutions. Our current membership of 17,000 comprises boards and directors from a variety of industries, including the kinds of firms overseen by the FRB—namely the holding companies of banks and savings and loans, state-chartered banks, and U.S. branches of foreign banks, as well as nonbank financial companies considered to be systemically important.

While all of these entities can benefit from the FRB's Board Effectiveness Guidance (BE guidance), such guidance will be particularly critical for large bank and savings and loan holding companies (those with total consolidated assets of $50 billion or more), and for systemically important nonbank financial companies under your supervision. We note that your BE guidance would be included in your supervisory standards for these institutions.

The Proposed Guidance

The FRB's proposed guidance lists five key attributes of effective boards (condensed below), which are very much aligned with NACD's own Key Agreed Principles (listed as an Appendix at the end of this letter):

- Set clear, aligned, and consistent strategic direction for the company.
- Actively manage information flow and board discussions.

- Hold senior management accountable.
- Support the independence and stature of independent risk management and internal audit.
- Maintain a capable board composition and governance structure.

The FRB has requested comments on these attributes. NACD would like to provide answers to questions most pertinent to our work.

What other attributes of effective boards should the Board assess? *(Question 2)*

Bank supervisors need guidance that focuses only on the most critical factors. The FRB's compact list serves that purpose. Bear in mind, however, that there is no end to the sage advice one can give boards. Indeed, one could list hundreds of attributes of board effectiveness. NACD has done so over time, issuing more than 20 Blue Ribbon Commission reports, typically with more than 10 recommendations per report. Other organizations, such as the Business Roundtable (BRT) and the Council of Institutional Investors (CII) have also issued standards, adding to the guidance. Clearly, a test with so many elements would be an unwieldy supervisory tool. Five years ago, NACD led an effort to create a short list of the most critical elements agreed upon by NACD, BRT, and CII, resulting in NACD's Key Agreed Principles listed at the end of this letter. These ten principles can be used to *enhance and expand* the list of attributes in the FRB's proposed guidance as follows (*enhancements and additions—**including topic headings**—added in italics*).

- ***Strategy:*** Set clear, aligned, and consistent strategic direction for the company. An effective board guides the development of and approves the firm's strategy and sets the types of levels of risk it is willing to take.
- ***Information and Decisions:*** Actively manage information flow and board discussions. An effective board of directors actively manages its information flow and its deliberations, so that the board can make sound, well-informed decisions in a manner that meaningfully takes into account risks and opportunities.
- ***Accountability:*** Hold senior management accountable *to the board, and hold the board accountable to shareholders and other stakeholders.* An effective board of directors holds senior management accountable for implementing the firm's strategy and risk tolerance and maintaining the firm's risk management and control framework. An effective board of directors also evaluates the performance and compensation of senior management. *At the same time, an effective board of directors understands its accountability to shareholders and other stakeholders, and communicates with them in a responsive and transparent manner.*
- ***Independence:*** *Support the independence of the board from management, as well as* the independence and stature of independent risk management and internal audit. An effective board of directors, through its risk and audit committees, supports the stature and independence of the firm's independent risk management and internal audit functions, and ensures the objectivity of external audit.
- ***Composition and Structure:*** Maintain a capable board composition and governance structure*, following a process led by the board and focused on board effectiveness.* An effective board has a composition, governance structure, and established practices that support governing the firm in light of its asset size, complexity, scope of operations, risk profile, and other changes that occur over time.

- ***Continuous Improvement.*** *Ensure alignment with shifting strategic needs through ongoing director education in the board room and beyond, and through effective succession planning that refreshes board composition as needed.*

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)*

In the 40 years since its founding, NACD has helped more than one thousand boards evaluate their performance. In NACD's most recent public company governance survey, 90% of respondents indicate that their boards perform self-evaluations of their effectiveness, and the vast majority evaluate themselves on annual basis. Full board self-assessments have become common practice. The five principles set forth by the FRB could be developed into a questionnaire for assessment by board members. With the help of a facilitator (which can be external or internal, such as the general counsel) it is possible to administer a confidential questionnaire, aggregate responses, and analyze results.

In NACD's 2016 Blue Ribbon Commission report on Building the Strategic-Asset Board, we made some key points that could help boards of banks evaluate their own performance. We emphasized that to evaluate their performance effectively, boards should:

1) Conduct annual full-board, committee, and individual-director evaluations at least once every other year.
2) Combine these formal assessments with additional opportunities to assess performance throughout the year, including informal evaluations at the end of board meetings or after important business or governance-related events such as CEO succession or major acquisitions.
3) Consider using a qualified independent facilitator.
4) Include feedback from management and others (e.g., 360-degree evaluation).

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)*

Yes, the guidance makes clear the role of the board versus the role of management. It is very much in line with our FAQ publication on this topic, as well as the Customizable Director Role Description we have provided to our members. Both publications list the decisions that only a board can make, such as declaring a dividend or selling the company, and explain the matters typically delegated to management, such as operations. We note with appreciation that the FRB's LFI Rating System proposal of August 17 "would revise certain supervisory expectations for boards to ensure they are aligned with the Federal Reserve's supervisory framework, and would eliminate redundant, outdated, or irrelevant supervisory expectations." NACD agrees with the concept behind this initiative.

Regarding the other three questions (1, 4, and 6), we are not prepared to answer them at this time, but will be watching for further developments.

Sincerely,

Peter R. Gleason, CEO
National Association of Corporate Directors

Dr. Karen Horn, Chair
National Association of Corporate Directors

APPENDIX

NACD's Key Agreed Principles to Strengthen Corporate Governance in U.S. Publicly Traded Companies (originally issued in 2008 and updated in 2011)

I. Board Responsibility for Governance: Governance structures and practices should be designed by the board to position the board to fulfill its duties effectively and efficiently.
II. Corporate Governance Transparency: Governance structures and practices should be transparent—and transparency is more important than strictly following any particular set of best practice recommendations.
III. Director Competency & Commitment: Governance structures and practices should be designed to ensure the competency and commitment of directors.
IV. Board Accountability & Objectivity: Governance structures and practices should be designed to ensure the accountability of the board to shareholders and the objectivity of board decisions.
V. Independent Board Leadership: Governance structures and practices should be designed to provide some form of leadership for the board distinct from management.
VI. Integrity, Ethics & Responsibility: Governance structures and practices should be designed to promote an appropriate corporate culture of integrity, ethics, and corporate social responsibility.
VII. Attention to Information, Agenda & Strategy: Governance structures and practices should be designed to support the board in determining its own priorities, resultant agenda, and information needs and to assist the board in focusing on strategy (and associated risks).
VIII. Protection Against Board Entrenchment: Governance structures and practices should encourage the board to refresh itself.
IX. Shareholder Input in Director Selection: Governance structures and practices should be designed to encourage meaningful shareholder involvement in the selection of directors.
X. Shareholder Communications: Governance structures and practices should be designed to encourage communication with shareholders.