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By electronic submission to www.federalreserve.gov

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

***Re: Comment letter on "Proposed* Guidance on Supervisory Expectations for Boards of *Directors" (Docket No. OP*-1570)**

Dear Ms. Misback:

Thank you for the opportunity to comment on the Federal Reserve's proposed guidance on supervisory expectations for boards of directors. I offer the following comments in my capacity as a faculty member at the University of Michigan's Ross School of Business, where I write and teach about financial regulation and corporate governance. The comments herein are based on my recent article, Board to Death: How Busy Directors Could Cause the Next Financial Crisis, 59 B.C. L. REV. ___ (forthcoming 2018).

I have joined a group of business, legal, and public policy scholars who urge the Board to withdraw or substantially revise the proposal because the guidance, as drafted, falls short of the high standard to which bank holding company directors should be held.[1] I am writing separately to highlight what I believe to be the proposal's most critical shortcoming: <u>the proposed guidance fails to acknowledge that the directors of the United States' largest financial institutions are too busy to execute their responsibilities effectively</u>. The Board should make clear that directors of large financial institutions must limit their outside commitments to ensure that they have sufficient time and attention to devote to their governance duties.

By any measure, corporate directors lead exceptionally busy lives. Many directors hold full-time executive positions, and most serve on the board of at least one other company. On one hand, directors might acquire valuable knowledge and practice by serving in governance capacities at other firms. On the other hand, however, outside commitments such as full-time jobs and other board seats can detract from a director's effectiveness because they limit the time and attention that the director can devote to company business.

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[1] Anat R. Admati et al., Comment Letter on Proposed Guidance on Supervisory Expectation for Boards of Directors.

The drawbacks of director busyness are especially severe for systemically important financial institutions (SIFIs) because of the unique governance demands imposed on their boards.[2] SIFIs' combination of high leverage and short-term funding, for instance, can trigger sudden liquidity and solvency crises. In addition, explicit and implicit government guarantees discourage a SIFI's creditors from monitoring the firm's risk-taking, thereby weakening a traditional corporate governance mechanism. These unique characteristics create the need for a SIFI's board to establish effective risk monitoring systems within the firm. Enhanced risk monitoring, however, is precisely the type of oversight that busy directors are ill equipped to provide.

My research identifies three specific ways in which busy directors impair oversight of senior management. First, directors with many outside commitments are less inclined to participate actively in corporate decision-making. Busy directors, for example, are more likely to miss board meetings, and board committees comprised of busy directors meet infrequently.[3] Second, directors with many outside commitments tend not to challenge management; as a result, firms with busy directors are more susceptible to managerial self-dealing, misconduct, and excessive risk-taking.[4] Third, busy directors experience attention shocks that distract them from company business. When a firm with which a director is associated experiences a major event—e.g., a merger or reorganization—the director's time commitment to that firm increases substantially. The director, in turn, neglects his or her other board memberships.[5]

In a series of case studies, my paper demonstrates how busy directors detract from corporate governance in practice. Consider, for example, JPMorgan's London Whale trading loss. As chair of JPMorgan's risk committee, James Crown bore responsibility for establishing and overseeing the firm's enterprise-wide risk management framework. At the same time, however, Crown had many other professional duties: he served as the lead independent director of both Sara Lee Corp. and General Dynamics Corp., and he ran his family's multi-billion dollar investment fund. Just as JPMorgan's traders began building their ill-fated derivatives positions in early 2012, Crown was busy conducting a search to replace Sara Lee's CEO, overseeing a spin-off of half of Sara Lee's business lines, and developing strategies for General Dynamics to cope with $1 trillion in recently-enacted defense budget cuts. While Crown attended to these crises, JPMorgan's risk management infrastructure failed to detect the escalating risks in the bank's credit derivatives portfolio, leading to $6 billion in losses and more than $1 billion in fines for inadequate risk monitoring.

The situation was similar with Wells Fargo's fraudulent accounts scandal. Wells Fargo's directors failed to respond to red flags regarding sales practices violations, at least in part, because they were

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[2] I define SIFIs to include the eight U.S. banking organizations that the Financial Stability Boards deems to be global systemically important banks (Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo) and the nonbank financial company currently supervised by the Board (Prudential Financial).

[3] See, e.g., Renee B. Adams & Daniel Ferreira, Do Directors Perform for Pay?, 46 J. ACCT. & ECON. 154, 162-63 (2008); Pornsit Jiraporn et al., *Too Busy to Show Up? An Analysis of Directors' Absences*, 49 Q. REV. ECON. & FIN. 1159, 1164-65 (2009).

[4] See, e.g., Flora Niu & Greg Berberich, Director Tenure and Busyness and Corporate Governance, 6 INT'L J. CORP. GOVERNANCE 56, 62, 64-65 (2015).

[5] See, e.g., Antonio Falato et al., Distracted Directors: Does Board Busyness Hurt Shareholder Value?, 113 J. FIN. ECON. 404 (2014).

among the most overcommitted bank directors in the country. Nine of Wells Fargo's 13 independent directors served on at least three public company boards. Risk committee chair Enrique Hernandez was particularly busy, sitting on the boards of four public companies and serving as CEO of a multinational, private company. Wells Fargo's directors were so busy that they rarely met as a full board or in their committees. Every year from 2012 to 2015, for example, Wells Fargo held fewer board and risk committee meetings than any of its peer banks. In sum, while Wells Fargo's employees opened millions of fake customer accounts, its board was missing in action as they attended to their other professional obligations.

All of this is not to say, of course, that JPMorgan and Wells Fargo necessarily would have averted their crises had their boards been less overcommitted. I argue, however, that JPMorgan and Wells Fargo would have been more likely to detect and address nascent risks if their boards—and especially their key directors—had been less busy.

Despite the dangers of director busyness, many SIFI boards remain alarmingly overcommitted. When compared to the directors of all S&P 500 firms, SIFI directors are significantly less likely to sit on only one public company board and more likely to sit on at least three public company boards.[6] The boards of a few SIFIs are especially overcommitted. Nearly two-thirds of Citigroup's independent directors, for example, hold three or more board seats.[7] Likewise, all of Morgan Stanley's key directors—its lead independent director and the chairs of its risk and audit committees—serve on three or more boards.[8]

Recognizing the risks of overcommitment, the European Union adopted regulations limiting outside employment and board seats for financial institution directors in 2013 (CRD IV).[9] The United States, by contrast, has not addressed the problem. The proposed guidance on supervisory expectations for board of directors is a critical opportunity for the Board to establish that SIFI directors must limit their outside commitments to ensure that they have sufficient time and attention to devote to their governance responsibilities.

Under CRD IV, a director of an EU financial company may not hold more than four board seats or, if the director is a full-time executive, more than two board seats (excluding his or her own company). EU regulators apply the CRD IV limits to many financial companies, including some with less than $1B in assets. The Board, by contrast, applies enhanced prudential standards to a much more limited set of firms with $50 billion or more in assets. Accordingly, the Board should adopt a numeric limit on directorships that is more stringent than under CRD IV. The Board 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).

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[6] Approximately 29% of SIFI independent directors sit on only one public company board, compared to 37% of all S&P 500 independent directors. By contrast, 41% of SIFI independent directors sit on three or more public company boards, compared to 33% of all S&P 500 independent directors.
[7] See Citigroup, Inc., Proxy Statement (Form DEF 14A) 44-58 (Mar. 15, 2017).
[8] See Morgan Stanley, Proxy Statement (Form DEF 14A) 6 (Apr. 7, 2017).
[9] Parliament and Council Directive 2013/36/EU, On Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms, 2013 O.J. (L 176) 338, art. 91.3.

The Board should go beyond CRD IV, moreover, and adopt additional restrictions for key directors. The directorship limitations in CRD IV apply uniformly to all members of a financial institution's board. Some financial institution directors, however, bear special responsibility for ensuring the firm's safety and soundness. A firm's lead independent director, risk committee chair, and audit committee chair, in particular, are critical to effective risk management.[10] These directors, therefore, should be uniquely focused on the firm. Accordingly, the Board should establish more stringent restrictions for each SIFI's three key directors. Specifically, the Board should limit SIFI lead independent directors, risk committee chairs, and audit committee chairs to serving on the board of one other public company. The Board, moreover, should not permit a current public company executive to serve in one of these key leadership roles, as it is unlikely that a sitting executive would be able to devote sufficient time and attention to the role.

There is, of course, a tension between trying to attract the strongest and most highly qualified directors for SIFIs and limiting their outside professional commitments. Director candidates already complain that serving on a financial company's board is unattractive due to onerous regulations and potential liability. Imposing limits on directors' outside commitments might further dissuade well-qualified candidates from serving. The Board, however, can limit the depletion of qualified and interested director candidates by applying the most stringent regulatory caps only to the SIFI directors in key leadership positions—about 30 directors in total. SIFIs, moreover, can ensure a consistent supply of well-qualified candidates who are willing to comply with limits on their outside commitments by increasing directors' pay to compensate them for foregone professional opportunities.[11]

Deterring SIFIs from misconduct and excessive risk-taking requires that their directors have sufficient time and attention to execute their governance roles effectively. The Board should adopt the proposed limitations on SIFI directors' outside commitments to enhance oversight of SIFI management and thereby help preserve the safety and soundness of the financial system.

Thank you again for this opportunity to comment on the proposed guidance. Please feel free to contact me if I can be of any assistance.

Sincerely,

Jeremy C. Kress
Senior Research Fellow, Center on Finance, Law, and Policy
Assistant Professor of Business Law (effective Fall 2018)

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[10] See Daniel K. Tarullo, Governor, Fed. Reserve Bd. of Governors, Remarks at Ass'n of Am. Law Schs. 2014 Midyear Meeting: Corporate Governance and Prudential Regulation (June 9, 2014) (emphasizing the importance of a firm's lead independent director, risk committee chair, and audit committee chair).

[11] To align directors' interests with those of other stakeholders in the firm, SIFIs should, to the extent possible, structure enhanced pay packages in compliance with compensation guidelines proposed by the financial regulatory agencies for executives and significant risk takers. See Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37,670 (proposed June 10, 2016).