February 15, 2018

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

Re: Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 Fed. Reg. 37219 (Aug. 9, 2017)

Dear Ms. Misback:

Better Markets[1] appreciates the opportunity to comment on the proposed guidance captioned above ("Proposal" or "Release") issued by the Board of Governors of the Federal Reserve System ("Federal Reserve").

We also appreciate the Federal Reserve's intentions and motivations in proposing this guidance, as discussed by then-Governor Jay Powell last August:

> "We do not intend that these reforms will lower the bar for boards or lighten the loads of directors. The new approach distinguishes the board from senior management so that we can spotlight our expectations of effective boards. The intent is to enable directors to spend less board time on routine matters and more on core board responsibilities: overseeing management as they devise a clear and coherent direction for the firm, holding management accountable for the execution of that strategy, and ensuring the independence and stature of the risk management and internal audit functions. These were all areas that

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

> were found wanting in the financial crisis, and it is essential that boards get these fundamentals right."[2]

His conclusion then remains critically important today:

> "We need financial institutions that are strong enough to support economic growth by lending through the economic cycle. To achieve that goal, we need strong and effective boards of directors at firms of all sizes."[3]

However, while we agree with these intentions and conclusions, it simply is not clear from the Proposal whether or not the proposed changes will achieve the Federal Reserve's stated goals for two key reasons. First, the extremely limited information provided in the Proposal makes it virtually impossible to comment effectively. In particular, the Federal Reserve states that the "proposal has been informed by a multi-year review by the Federal reserve of practices of boards of directors, particularly at the largest banking organizations."[4] Yet, the Proposal provides virtually no information about—

- how the review was designed and conducted;
- the participants involved, such as units within the Federal Reserve, other regulatory agencies in the U.S. or elsewhere, banks or other financial institutions, public interest advocates, academics or other outside experts, and any other concerned parties that provided input during the review;
- the content and findings of the review; or
- how the results were analyzed and by whom, among other key details.

At a minimum, that information must be disclosed in detail for the public to be sufficiently informed to provide meaningful comment.

Second, then-Governor Powell correctly noted in his August speech that "These were all areas that were found wanting in the financial crisis, and it is essential that boards get these fundamentals right."[5] However, the Proposal fails to address critical questions that arise from this observation: If these proposed changes had been in place prior to the 2008 financial crisis, would they have made a material observable difference in reducing or avoiding the type of catastrophic financial institution failures that we witnessed during the crisis and, if so, how? While the answers to these questions are not the sole test for evaluating the Proposal, they certainly must be among the most important metrics. Therefore, the Federal Reserve should expressly address these questions so that the public can better understand the likely impact of the Proposal and offer more meaningful comment on it.

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[2] Jerome Powell, Governor, Fed. Reserve System, Remarks at Large Bank Directors Conference: The Role of Boards at Large Financial Firms 3 (Aug. 30, 2017) https://www.federalreserve.gov/newsevents/speech/files/powell20170830a.pdf.

[3] *Id.* at 6

[4] Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 Fed. Reg. 37219, 37219 (Aug. 9, 2017).

[5] Powell, *supra* note 2 at 3.

Thus, we believe that the Proposal must be re-proposed and must include the material information discussed in this comment letter.[6] As discussed in greater detail below, while the Proposal may offer limited benefits in terms of clarifying the proper roles and attributes of effective boards of directors at financial institutions, the new guidance lacks material information, sets expectations that are too low, and even threatens harm by rescinding some important existing supervisory practices that help boards discharge their core duties.

BACKGROUND

Boards of directors are, in principle, one of the most important forces in determining the extent to which a financial institution abides by the law, avoids excessive risk, and generally serves the needs of investors and the real economy. Unfortunately, the board governance system has failed repeatedly and on a grand scale to meet those challenges and attain those goals. The financial crisis of 2008 is the most compelling modern illustration of the devastating consequences[7] that follow when boards at major banks and other financial institutions actively pursue, or turn a blind eye to, virtually unbridled risk in the chase for profits and bonuses or in response to real or perceived competitive pressures.[8]

It is worth remembering that virtually every single major financial institution in the U.S. failed or would have failed without substantial government rescue programs, including bailouts and backstops beginning in 2007 and continuing for years thereafter. For example, as reflected in an internal Federal Reserve email on September 20, 2008, both Morgan Stanley and Goldman Sachs were on the verge of bankruptcy:

> "'FYI, [Morgan Stanley] called [NY Fed. President Tim Geithner] late last nite [sic] [Friday September 19, 2008] and indicated they cannot open on Monday [September 22, 2008]. [Morgan Stanley] advised [Goldman Sachs] of this and

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6 In addition, we would also suggest that the Federal Reserve's re-proposal specifically analyze and discuss its recent action against Wells Fargo, including in particular its cease and desist order. For example, how would the provisions of the Proposal have changed the conduct of Wells Fargo and its board if they had been in place in the years before the misconduct received widespread public attention in September 2016? This would be particularly valuable in light of the report of the independent directors of the board of directors. *See, e.g.,* Indep. Dirs. of the Bd. of Wells Fargo & Co., *Sales Practices Investigation Report*, (Apr. 10, 2017), https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf?https://www.wellsfargo.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf.

7 *See* Better Markets, *The Cost of Crisis, $20 Trillion and Counting* (July, 2015), https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

8 The 2008 financial crash is not the only example. The scandals that brought down Enron, Worldcom, and many other companies in the mid-2000s followed the dot-com bust in the early-2000s. And, of course, there was also the Long Term Capital Management implosion, not long after the S&L crisis.

> [Goldman Sachs] is now panicked because they feel that if [Morgan Stanley] does not open, then [Goldman Sachs] is toast . . . .'"[9]

While the de facto nationalization of the financial system in 2008-2009 has obscured this history, the extraordinary series of egregious and widespread failures and near-failures during the crisis was almost unprecedented and should still be uppermost in regulators' minds as they contemplate changes to financial regulations and supervisory practices.

While there were many reasons for this, the unsettling and undeniable truth behind former Citigroup CEO Chuck Prince's infamous quote was a culture of willing and knowing irresponsible risk-taking, often due to competitive pressures:

> "As long as the music is playing, you've gotta get up and dance . . . ."[10]

Morgan Stanley's CEO John Mack recognized this after the crash when he said:

> "We cannot control ourselves. You [lawmakers and regulators] have to step in and control the Street. Regulators? We just love them."[11]

The unfortunate truth is that once any one of the systemically significant financial firms starts to engage successfully in high-risk, high-return activities, the competitive pressure to achieve ever-rising revenues, profits, bonuses, and stock prices pushes them all into dangerous, inappropriate activities. The board of directors must be a much stronger first line of defense in preventing this, but that requires clear rules and standards that can only be established and enforced by regulators and supervisors.

Weak boards were and remain a core part of the problem. They have tolerated if not actually incentivized a culture of risk-taking that has led to recklessness, misconduct, lawlessness, and customer exploitation. Now is precisely the time to better equip boards to serve their oversight role and to hold them more accountable than ever. To do that, the Proposal should be withdrawn and re-proposed with additional detailed information or, failing that, it should be amended in numerous respects, as described below, to move in that direction.

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9 Email from Michael Silva, Federal Reserve Bank of New York, to Christine Cummings, Update (Sept. 20, 2008), http://www.nakedcapitalism.com/wp-content/uploads/2014/11/Screen-shot-2014-11-12-at-4.57.23-AM.jpg.

10 Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-outs*," Financial Times (July 9, 2007), https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac.

11 *Regulators? We Just Love 'em, says John Mack*, The Evening Standard (November 19, 2009), https://www.standard.co.uk/business/regulators-we-just-love-em-says-john-mack-6744822.html; *see also*, *Morgan Stanley's Mack: 'We Cannot Control Ourselves*, The New York Times Dealbook, (November 19, 2009), https://dealbook.nytimes.com/2009/11/19/morgan-stanleys-mack-we-cannot-control-ourselves/.

OVERVIEW OF PROPOSAL

The overarching goal of the Proposal is to amend the supervisory expectations for boards of directors at financial institutions to more sharply focus their efforts on core board responsibilities. As explained in the Release, the aim is to ensure that boards no longer devote "significant" amounts of time "satisfying supervisory expectations that do not directly relate to the board's core responsibilities," which include strategic planning, risk management, oversight of senior executives, and compliance.[12]

For the ostensible purpose of furthering these goals, the Proposal has three components:

- First, it would fundamentally change the Federal Reserve's existing practice regarding the communication of supervisory findings to boards. It would provide that most Matters Requiring Attention ("MRA"s) and even more urgent Matters Requiring Immediate Attention ("MRIA"s) will be directed to senior management for corrective action, not to boards. Again, the premise appears to be that this change would free boards to focus more on their core responsibilities. And it would apply to all financial institutions supervised by the Federal Reserve.[13]

- Second, it would establish new supervisory guidance to promote effective boards. The guidance would clarify supervisory expectations for boards as distinct from senior management, and it would identify five "key attributes" of effective boards that the Federal Reserve would use when assessing a firm's board of directors.[14] This guidance would apply only to bank and savings and loan holding companies with total consolidated assets of $50 billion or more and to systemically important nonbank financial companies designated by the FSOC for supervision by the Federal Reserve.[15]

- Finally, it would revise or eliminate existing supervisory guidance found in 27 Supervision and Regulation ("SR") letters for bank and savings and loan holding companies of all sizes. The Proposal notes that it would "eliminate redundant, outdated, or irrelevant supervisory expectations" for boards.[16]

The Release states that the basis for the Proposal is an undisclosed "multi-year review by the Federal Reserve of practices of boards of directors, particularly at the largest banking organizations."[17] However, the Proposal provides no detail about the methodology, participants, or specific findings in the review, or how it was analyzed and interpreted for purposes of drafting the Proposal. Moreover, the Proposal provides no means of gaining

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12 Release at 37219.
13 *Id.* at 37220.
14 *Id.* at 37219-20.
15 *See id.*
16 *Id.* at 37220.
17 *Id.* at 37219.

access to any written report or any other documents reflecting the review. Furthermore, the Proposal relies in part on information gathered from "discussions with independent directors."[18] Here again, the Proposal offers no details about the number, nature, or content of those discussions, or with whom they were conducted. This lack of information makes it impossible for commenters to provide fully informed, meaningful input about the process, resulting in a deficiency that can only be remedied with a much more detailed re-proposal.

SUMMARY OF COMMENTS

While the goal of enhancing the effectiveness of boards of directors at financial institutions is unquestionably an important and appropriate regulatory objective, we believe that the Proposal suffers from a number of specific weaknesses. In addition to its lack of transparency, the Proposal is unsupported by any analysis showing that it would confer significant benefits in terms of helping to avoid the type of bank failures that can trigger and prolong a financial crisis. Furthermore, it would restrict the flow of important information to boards, establish incomplete performance expectations, and repeal some valuable supervisory guidance that already draws appropriate lines between board oversight and senior management responsibilities.

In summary—

- The basis for the Proposal lacks is far too opaque. The justification for pushing forward with these significant changes in supervisory guidance is described in vague and passing references to a "multi-year review," a series of "discussions," and the like.[19] It is therefore impossible to assess the nature and the severity of the real-world problems under the current regulatory framework that allegedly justify the proposed changes.[20]

- The Proposal does not address or analyze a critically important question: To what extent would the proposed changes have helped financial institutions avoid the management failures that led to catastrophic losses and the collapse or near collapse of so many firms leading up to and during the financial crisis of 2008. This is both a goal of and a key litmus test for any proposal that seeks to alter the supervisory expectations for financial institution boards.

18 Release at 37219.

19 *Id.*

20 To the extent the notice and comment requirements of the Administrative Procedure Act ("APA") are applicable to the Proposal, the lack of information about the review process makes it impossible to know whether the Federal Reserve is considering all the relevant factors in connection with the Proposal, as the APA requires. *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 34 (1983) (holding that an agency must provide "an adequate basis and explanation" for rulemakings); *see also Gen. Elec. Co. v. Envtl. Protect. Agency*, 290 F.3d 377, 385 (D.C. Cir. 2002) (holding that though agency actions purport to be guidance, if they carry "the force of law" they must still comply with the APA notice and comment procedures).

- Fundamentally changing the existing practice and directing all future MRA and MRIAs to management instead of to the board for corrective action is a mistake. This would deprive boards of information they must have to discharge their important oversight duties. Moreover, the suggested approach exacerbates a fundamental concern articulated in the Proposal itself—that **boards "are inherently disadvantaged given their dependence on senior management for the quality and availability of information."**[21] The Federal Reserve should rethink this aspect of the Proposal. It should either leave the existing practice intact, as set forth in SR letter 13-13 and CA letter 13-10, or at a minimum, establish a presumption that all MRIAs must be transmitted to the board, coupled with a clear and appropriately tailored exception for MRAs that truly lack the urgency and importance warranting prompt board attention. In addition, the Proposal must require that Boards receive regular summary reports listing all pending MRIAs and MRAs and establishing a timeline for their prompt resolution.

- The five new attributes of effective boards of directors are reasonable as far as they go, but they are incomplete. They should be expanded to include three additional metrics for assessing the effectiveness of a board: (1) strong compliance policies and practices, including provisions for independent Chief Compliance Officers insulated from management pressure and with direct access to the board or appropriate subcommittee; (2) limits on compensation practices that encourage excessive risk-taking, including mandatory claw back provisions for erroneously awarded incentive-based compensation; and (3) a framework for considering long-term value as part of the governance process, including environmental, social justice, and other factors that not only serve the broader public interest, but are also proven hallmarks of financial outperformance.[22]

- The approach to modifying 27 existing SR letters, as set forth in the Proposal, suffers from two defects. First, it lacks transparency, as the Release provides no details regarding the actual changes that are contemplated or the particularized basis for them, only the general principles that will guide the process. This does not provide stakeholders with enough information to offer comment.[23] Second, even as vaguely described, the proposed changes appear unnecessary and counterproductive: The SR letters already appropriately differentiate the roles of board and management, and further narrowing the board's duties will undermine

[21] Release at 37219 (emphasis added).

[22] *See, e.g.,* Andreas Feiner, *From The Stockholder To The Stakeholder: How Sustainability Can Drive Financial Outperformance*, The London Accord (Mar. 2015), http://www.longfinance.net/programmes/london-accord/la-reports.html?view=report&id=464; *see also* Morgan Stanley, *Sustainable Reality: Understanding the Performance of Sustainable Investment Strategies*, Morgan Stanley Institute for Sustainable Investing (Mar. 2015), https://www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf.

[23] This too conflicts with the APA requirement that an agency proposal contain sufficient detail to allow for meaningful public comment.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

the sound oversight of financial institutions—which have a profound impact on consumers, financial markets, communities, and the entire economy.

COMMENTS ON THE PROPOSAL

1. **The Proposal omits essential information about the review that served as its foundation.**

The Release indicates that the basis for the Proposal is a "multi-year review by the Federal Reserve of practices of boards of directors, particularly at the largest banking organizations."[24] However, nothing in the Release explains the methodology used, its scope, its timeframe, the sources of information gathered, who provided input for the review, the specific findings it produced, or any other critical details. Moreover, the Release does not cite or link to any reports used in, related to, or arising from the review. The Release also alludes to informal information-gathering steps as the basis for some aspects of the Proposal, including "discussions with independent directors" and "responses to questions from supervised institutions."[25] Here too, no detail regarding the number, nature, scope, source, or content of these interactions is provided in the Release.

As a result of this grossly deficient disclosure, the public—which as proven in 2008 has a huge stake in the way financial institutions manage risk and treat investors—cannot possibly evaluate the extent to which the Proposal is actually necessary and springs from real and widespread data-driven deficiencies in the current supervisory approach. This deficit in the Proposal assumes special significance because it is a significant de-regulatory initiative. This is too reminiscent of the recent wave of deregulatory proposals that are often marked by a stunning lack of empirical support. They too often rest primarily on baseless assertions that the regulatory reforms now in place, including those implemented in accordance with the Dodd-Frank Act, are overly burdensome for the regulated industry and are stifling our markets, our economy, and our overall level of prosperity.

Omitted from these de-regulatory claims are the real data, which show that our markets are thriving and that far from hampering growth and prosperity, financial regulation is creating the conditions for the sustained and long-term vitality of our financial system and ultimately our economy.[26] Also absent from these de-regulatory initiatives is any legal analysis shedding light on whether and to what extent they actually conflict with the language and remedial purposes of the various organic statutes governing the financial regulatory agencies. Finally, and most importantly, these efforts at de-regulation almost entirely ignore the lessons we should have learned from the financial crisis of 2008: The

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24 Release at 37219.
25 *Id.* at 37219, 37226.
26 *See*, *e.g.*, Yalman Onaran, *U.S. Mega Banks Are This Close to Breaking Their Profit Record*, BloombergMarkets (July 21, 2017, 5:00AM), https://www.bloomberg.com/news/articles/2017-07-21/bank-profits-near-pre-crisis-peak-in-u-s-despite-all-the-rules.

reforms in place are and will continue to be essential in preventing a future financial crisis, which would do vastly more to destroy markets, productivity, and prosperity than any set of rules and regulations possibly could.

This pattern of pushing for de-regulatory changes without regard to the facts and the attendant risks is relevant here because without more information about the basis for the Proposal, it is impossible to fully assess whether it will actually fortify our regulatory structure governing financial institution boards and help prevent future crises, or potentially weaken that structure and create gaps and vulnerabilities.

Accordingly, rather than vaguely alluding to a "review," a number of "discussions," and "answers to questions" as the basis for the Proposal, the Federal Reserve should provide a concrete, evidence-based justification, with details regarding the review and all other information-gathering efforts that informed and provided the basis for the Proposal. And it should include a legal analysis showing how each component of the Proposal adheres to and furthers the purposes of the applicable banking law provisions.

2. **The Proposal must address this question: If implemented pre-crisis, would the proposed guidance have mitigated the number and gravity of bank failures that led to the crisis and how?**

In the area of prudential regulation of financial institutions, a critical test for any proposed new regulation or modification of an existing rule or guidance should be the extent to which the change would help reduce the likelihood of bank failures, resulting episodes of systemic instability, and eventual crisis. In this case, the Proposal fails to address this central question. As explained below, the review that preceded the Proposal may have delved into this issue, but the Proposal offers almost no specifics about the nature and findings of that review. In addition, while the substance of the Proposal may to some degree enhance compliance, risk management, and institutional stability by more clearly defining the role of a board, the benefit of this approach would seem to be offset by the restricted information flow to boards contemplated in the Proposal.

In any event, the central point is that the Proposal should explain how and to what degree the suggested changes in supervisory guidance would be likely to minimize the risk of institutional failure that characterized the financial crisis. This would not only enhance the credibility of the Proposal but also allow the public to provide meaningful comment.

3. **The Proposal would impair the ability of boards to discharge their duties by restricting information flow.**

The Proposal would radically reduce the flow of highly material information to boards of directors, thereby impairing, not enhancing, their ability to discharge their core

oversight responsibilities. Specifically, the Proposal would rescind the Federal Reserve's current policy of transmitting all MRAs and MRIAs directly to the board and instead provide for those supervisory communications to be sent only to senior management. This change goes too far. It would undermine the ability of boards to oversee the management of their institutions. At the same time, it could facilitate the evasion of responsibility by some boards, who will be better positioned to insist they had no knowledge of illegal, reckless, or imprudent conduct.

Recent events have made clear the importance of robust information flow to the boards of financial institutions. For example, on February 2, 2018, the Federal Reserve announced an enforcement action against Wells Fargo in response to the bank's egregious, widespread, and long-running abuses affecting millions of customers.[27] The Board singled-out poor information flow from management to the Board as a primary factor in the compliance breakdowns experienced at the bank:

> "The firm's lack of effective oversight and control of compliance and operational risks contributed in material ways to the substantial harm suffered by WFC's customers. **Specifically, the board of directors must take steps to improve reporting from senior management.** As the April 10, 2017, Sales Practices Investigation Report (commissioned by the independent directors of the board) noted, starting in February 2014 and continuing thereafter, the board and certain committees of the board received from management assurances that Corporate Risk, Human Resources, and the Community Bank were undertaking enhanced monitoring of sales practice misconduct and were addressing sales practice abuses. Management's reports, however, generally lacked detail and were not accompanied by concrete action plans and metrics to track plan performance. **The board should have received more detailed and concrete plans from senior management on such a critical issue.**[28]"

In other words, another test for evaluating a proposed change in supervisory guidance is whether it would, if implemented, prevent or substantially decrease the likelihood of fraud and other customer abuses. With respect to the Proposal, the answer appears to be no, as it would constrict rather than enhance information flow to financial institution boards.

As discussed above, it is impossible to determine how the "review" supports this proposed change, since no details regarding the review are set forth in the Release. Furthermore, as shown below, the specific justifications proffered in the Release are unpersuasive, and the two narrow exceptions in the Proposal would not significantly

[27] Letter from the Bd. of Govs. of the Fed. Reserve System to Bd. Of Dirs. of Wells Fargo & Co. (Feb. 2, 2017), https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a2.pdf.
[28] *Id.*

mitigate the harms threatened from this change in policy. Finally, this aspect of the Proposal would have a broadly negative impact, since it would apply to all institutions supervised by the Federal Reserve.

A. The information is important.

As a threshold point, the information contained in MRIAs and MRAs is on its face highly material to a board's oversight function. The Proposal describes MRIAs as "matters of significant importance and urgency that the Federal Reserve requires a supervised institution to address immediately."[29] It goes on to explain that such matters include those—

(1) that "have the potential to pose **significant risk to the safety and soundness** of the institution;"

(2) that "represent **significant noncompliance with applicable laws** or regulations;"

(3) that constitute "**repeat criticisms that have escalated in importance** due to insufficient attention or inaction by the institution;" and

(4) that "have the potential to cause **significant consumer harm**."[30]

MRAs rise to nearly the same level of importance. They are matters concerning the same basic array of threats to an institution as MRIAs, including destabilizing and lawless conduct, but they pose less urgency because the harm is less imminent. The Release explains that issues giving rise to MRAs are "important" and "must be addressed to ensure the institution operates in a safe-and-sound and compliant manner," although the threats to safety and soundness and to consumer protection are considered "less immediate."[31]

In addition, MRAs deserve to be viewed as potentially critical in importance since they can quickly rise to the level of MRIAs as a result of "changes in circumstances, environment, or strategy."[32] In addition, MRAs can be elevated to MRIAs if an institution fails to adequately address an MRA in a timely manner."[33]

Given the weight and urgency of both MRIAs and MRAs, information about them would seem to be indispensable for any board truly committed to responsible stewardship of a financial institution.

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29 Release at 37226.
30 *Id.* (emphasis added).
31 *Id.*
32 *Id.*
33 *Id.*

B. The Proposal would intensify board dependence on management for information and potentially diminish board accountability.

By virtue of this proposed change, boards will be significantly more dependent on management for information flow. This is a problem, not a virtue, as the Release itself acknowledges:

> "Although boards have oversight responsibilities over senior management, they are inherently disadvantaged given their dependence on senior management for the quality and availability of information."[34]

In other words, supervisory standards must account for the innumerable reasons why senior management may be disinclined to provide complete, accurate, and timely information to the board, especially when management's own failings are at risk of exposure. The Proposal aggravates rather than addresses this problem by diverting critical information to management instead of the board.

Finally, the Proposal will actually diminish rather than enhance board accountability. By preventing or at a minimum delaying the transmittal of important information to the board, the Proposal would enable a board to disclaim responsibility for excessive institutional risk-taking or outright misconduct by asserting they were never alerted to the deficient, reckless, illegal, or abusive activity.

C. The changes are not justified by concerns about enmeshing boards in problem-solving or overloading them with information.

The generic, unparticularized justifications offered in the Release are unpersuasive. The first rationale appears to be that boards will consider themselves duty bound to become directly involved in solving the problems raised in MRIAs and MRAs, thus becoming overburdened and diverted from high-level oversight of the institution. For example, the Release notes that the current approach "has in many cases led boards of directors to believe they should become directly involved in addressing the MRIA or MRA."[35]

There are multiple flaws in this argument. First, as noted above, the underlying factual basis remains shrouded in mystery, as the Release provides no detail regarding the "many cases" in which boards were drawn into a direct remedial role. How many? Involving what circumstances and firms? Over what time span? And with what consequences?

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34 Release at 37219.
35 *Id.* at 37222.

Second, the current guidance already explicitly addresses this issue, as it does not actually require or even envision that boards will become directly involved in resolving the problems raised in MRIAs and MRAs. As the **current** SR explains—

> While boards may not directly undertake the work to remediate supervisory findings as senior management is responsible for the organization's day-to-day operations, it is nevertheless important that the board **be made aware of** significant supervisory issues **and ultimately be accountable for** the safety and soundness and assurance of compliance with applicable laws and regulations of the organization.[36]

These observations remain squarely relevant today: Boards are not and should not be required to themselves remediate the problems flagged in MRIAs and MRAs, but it is in any case critical for the board to receive the information and to decide for itself how best to ensure that the institutional response is effective and timely.

The Release also indicates that the Federal Reserve is concerned about information overload among boards: "[T]he results of the review suggest that boards of large financial institutions face significant information flow challenges, especially in preparing for and participating in board meetings."[37] But assuming this is true—as we must without any details regarding the "review" itself[38]—the best regulatory response can hardly be to cut the board off from some of the most important and pressing information being transmitted by the supervising authority, which is sounding alarms about the safety and soundness of the institution or potentially large-scale violations of law or patterns of customer abuse.

In any event, both the current SR and the Release suggest effective alternative mechanisms for protecting boards from information overload, even if such complaints were valid. The current SR already stipulates that supervisory findings in MRIAs and MRAs must be "(1) written in clear and concise language; (2) prioritized based upon degree of importance; and (3) focused on any significant matters that require attention."[39] These requirements currently help to minimize the risk of board overload or confusion. In addition, the Release itself suggests remedies for any information overload that might befall

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36 Bd. of Govs. of the Fed. Reserve System, SR 13-13, Supervisory Considerations for the Communication of Supervisory Findings Attachment, 1 (June 17, 2013) ("SR 13-13 Attachment") (emphasis added). Frankly, the Federal Reserve should be concerned about the qualifications of directors who fail to fully appreciate their oversight role and feel compelled to become directly involved in solving the problems raised in MRIAs and MRAs rather than making sure management performs that function.

37 Release at 37219.

38 For example, where does this overload come from? Is it the same across institutions? Is it poor management and weak control over information flow or is it in fact due to an avalanche of genuinely critical and required information? These and many more questions would be answered by a systemic, data-driven review which was fully disclosed so that the public would be equipped to provide informed comment.

39 SR 13-13 Attachment, *supra* note 36 at 2.

senior management under the new reporting regime. It makes clear that examiners and supervisory staff are expected to provide "sufficient clarity in the MRIA or MRA for senior management to [readily] understand supervisory expectations for corrective action and the timeframe for taking such action."[40] The Release goes on to suggest that "[h]ighly technical subcomponents of recommendations may be provided to management separately from the examination or inspection report . . . ."[41] If these practical suggestions would help senior management cope with information flow, they would be equally helpful to members of the board.

A final observation rebuts both concerns about drawing a board into a hands-on role and overloading it with information: If a financial institution were facing so many MRIAs and MRAs that such concerns were to become real, then the institution would be facing a management crisis. Under those circumstances, the board would be compelled to institute major changes in management personnel, structure, and processes. The remedy would certainly not be restricting the flow of information to the board.

D. The exceptions would do little to mitigate the harm from the Proposal.

The two exceptions set forth in the Proposal would do little to ensure that the board is receiving the information it needs in a timely fashion. The first is vague and unmanageable, and the second entails too much delay.

The language in the Proposal indicates that "where significant weaknesses in an institution's board governance structure and practices are identified," examiners would direct MRIAs and MRAs to the institution's board "for corrective action in the first instance."[42] However, this standard is simply too narrow. For the reasons explained above, the board should be made aware of a broader range of material issues, not only those related to the board itself. Far simpler and more effective at promoting strong board oversight would be simply retaining the current bright-line guidance requiring all MRIAs and MRAs to be shared with the board.

The second exception set forth in the Proposal provides that when senior management fails to take appropriate action to correct material deficiencies or weaknesses, examiners "would escalate such matters to an institution's board of directors."[43] This approach needlessly injects potentially significant delay into the institution's process for responding to important matters. The result will certainly be instances where matters are ultimately directed to the board but not before management has engaged in mismanagement or misconduct, or has allowed such conduct to persist for a significant period of time, to the detriment of customers, shareholders, and the institution itself. Once again, the simpler and

40 Release at 37226.
41 *Id.*
42 *Id.* at 37227.
43 *Id.*

more effective approach would be to alert the board in every case, along with senior management.

E. The Proposal must be amended to address these issues.

To address the foregoing concerns, the Proposal should be revised in several respects. At a minimum, it should continue the requirement that all MRIAs be transmitted to the board. MRAs could be exempted from this requirement, provided the Proposal establishes a clear and appropriately tailored exception for MRAs that truly lack the urgency and importance warranting prompt board attention. In any event, the Proposal must also require that Boards receive regular summary reports listing all pending MRIAs and MRAs and establishing a timeline for their prompt resolution. Without receiving this information, boards will be ill-equipped to ensure that senior management rectifies all MRIAs and MRAs in an effective and timely manner and to discharge their ultimate duty to safeguard the well-being of the financial institution.

4. The criteria used to identify effective boards of directors should be enhanced.

The Proposal includes guidance that "focuses on five key attributes of an effective board rather than on process-oriented supervisory expectations that do not directly relate to the board's core responsibilities."[44] The five attributes are described as follows:

1. "Set Clear, Aligned, and Consistent Direction," with an emphasis on setting the types and levels of acceptable risk;

2. "Actively Manage Information Flow and Board Discussions," including basic functions such as gathering necessary information and actively planning the agendas for board meetings;

3. "Hold Senior Management Accountable," including evaluation of the performance and compensation of senior management;

4. "Support the Independence and Stature of Independent Risk Management and Internal Audit," through the risk and audit committees; and

5. "Maintain a Capable Board Composition and Governance Structure," with a focus on ensuring a diversity of skills and perspectives and an ability to assess a board's own strengths and weaknesses.[45]

While these attributes of effective boards are basically appropriate, they fall short of what is necessary, and they must be fortified in several important respects.

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44 Release at 37224.
45 *Id.* at 37224-26.

- The five attributes do not sufficiently emphasize compliance. Although attention to compliance is mentioned in passing as a component of some of the five attributes, it deserves much greater emphasis under a separate heading. For example, a sixth attribute should make clear that effective boards must establish and maintain independent Chief Compliance Officers, properly insulated from senior management and with a direct reporting line to independent members of the board.[46]

- The five attributes do not adequately address the board's duty to ensure that appropriate compensation structures are in place, once again mentioning compensation only in passing. Specifically, a separate new attribute should be added making clear that boards have a duty to eradicate compensation structures that encourage excessive risk-taking or violations of law. In addition, it should provide that to be deemed effective, boards must ensure that strong and mandatory claw back measures are in place to recover compensation from managers who violate the law, undertake excessive risk, or engage in any other decision-making that inflicts significant harm on the institution or its customers.[47]

- The five attributes pay almost no heed to long-term value. Boards should be expected to place more emphasis on ensuring that financial institutions consider the long-term viability of the institution when developing and implementing their strategic plans and governance structures. In addition, many boards must expand the factors they consider to include environmental, social justice, and wholistic governance considerations. Increasingly, institutional investors, asset managers, academics, and others are advocating for this longer, broader, and more value-driven perspective in the board room.[48] In particular, the increasingly apparent costs posed by extreme weather events[49] and cyber-attacks,[50] have exposed the pressing need for boards to consider ESG and related issues. Additionally, mounting evidence suggests that this approach to corporate governance simultaneously maximizes shareholder value **and** societal value.[51]

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[46] Better Markets, Comment Letter on Chief Compliance Officer Duties and Annual Report Requirements (July 7, 2017), https://bettermarkets.com/rulemaking/better-markets-comment-letter-cftc-chief-compliance-officer-duties-and-annual-report.

[47] Better Markets, Comment Letter on Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices (Aug. 30, 2017), https://bettermarkets.com/rulemaking/better-markets-comment-letter-sound-compensation-practices.

[48] *See, e.g.,* Ronald P. O'Hanley, *State Street Global Advisors, Long-Term Value Begins at the Board*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 7, 2017), https://corpgov.law.harvard.edu/2017/03/20/long-term-value-begins-at-the-board/

[49] *See* National Oceanic and Atmospheric Administration, *Billion-Dollar Weather and Climate Disasters: Overview*, National Centers for Environmental Information, https://www.ncdc.noaa.gov/billions/.

[50] *See* Giovanni Bruno, *Equifax Tumbles on Reports That Hackers Might Have Struck Again*, TheStreet.com (Oct. 12, 2017), https://www.thestreet.com/story/14341111/1/equifax-data-breach.html.

[51] *See, e.g.*, Gunnar Friede, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. of Sustainable Finance & Investment, 210, 225 (2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699610.

With these enhancements, the list of attributes of effective boards can serve as a stronger and more complete guide, for the ultimate purpose of ensuring that financial institutions remain stable, continue to thrive, and serve the needs of consumers, the real economy, and the broader public interest, all while improving performance for shareholders.

5. **The proposed changes to the SR letters are vague and inherently questionable, as those letters already appropriately recognize the different roles of boards and senior management.**

As a preliminary matter, the proposed revisions to the collection of SR letters lack transparency and specificity. The Proposal identifies 27 SR letters—hundreds of pages of guidance—that the Federal Reserve intends to revise or eliminate entirely. The apparent goal is to rid those SR letters of board expectations that are unnecessary, redundant, or outdated so that boards will focus more time on their core responsibilities.[52] However, the Release fails to identify any of the specific modifications or rescissions that the Federal Reserve intends to make; it only indicates that they will be altered "so that [they are] aligned and consistent with the proposed BE guidance [for larger institutions] or SR 16-11 [for smaller institutions]."[53] Obviously, it is impossible to comment specifically on proposed revisions in the SR letters without seeing those proposed revisions.[54]

This lack of specificity is significant for two reasons. First of all, the targeted SR letters address a broad range of activities, many of which are at the heart of prudent financial institution governance. They include supervisory guidance in the key areas of "asset securitization activities" (SR 90-16)[55]; "lending standards for commercial loans" (SR 98-18)[56]; the "consolidated supervision framework for large institutions" (SR 12-17)[57]; and "consolidated recovery planning" ("bank living wills") (SR 14-8).[58]

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52 Release at 37220.

53 *Id.* at 37221.

54 We realize that the Federal Reserve is engaged in an ongoing effort to update the substance of it SR letters, to reflect changes in law, including the reforms implemented by the Dodd-Frank Act. It should be obvious that, to the extent substantive updates to the 27 letters cited in the Release are incomplete, the Federal Reserve should devote its resources to that effort rather than attempting to fine-tune supervisory expectations for boards, as it seeks to do in the Proposal. In addition, it is again worth observing that measured by the most basic requirements of the APA, which include the obligation to explain any proposal with sufficient detail to enable meaningful comment, the Proposal does not pass muster.

55 Bd. of Govs. of the Fed. Reserve System, SR 90-16, Implementation of Examination Guidelines for the Review of Asset Securitization Activities, 1 (May 25, 1990) ("SR 90-16").

56 Bd. of Govs. of the Fed. Reserve System, SR 98-18, Lending Standards for Commercial Loans, 1 (May 25, 1990).

57 Bd. of Govs. of the Fed. Reserve System, SR 12-17, Consolidated Supervision Framework for Large Financial Institutions, 1 (Dec. 17, 2012).

58 Bd. of Govs. of the Fed. Reserve System, SR 14-8, Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies (Sept. 25, 2014) ("SR 14-8").

Second, the SR letters in their current form already set forth appropriate expectations for boards with respect to their subject matter areas, recognizing the important oversight role of boards without enmeshing them in matters of routine management. It is therefore unclear from the general guidelines set forth in the Release how they could be revised to better achieve this balance. Several examples stand out.

- SR letter 14-8 sets forth the factors a systemically important bank holding company's board of directors should consider when planning for an economic downturn.[59] This is exactly the type of planning that a board of directors needs to be heavily involved in, as it involves a firm's governance structure, its long-term business strategy, and its operations that could pose a risk to the financial stability of the United States.[60]

- SR letter 00-9, addressing equity investment activities, already clearly delineates between the role of the board and the role of senior management.[61] The letter makes clear that a board should approve general investment policies, actively monitor investment performance, and ensure that there is an effective management structure in place for conducting the institution's equity activities.[62] The letter goes on to appropriately specify the contrasting role of senior management in terms of managing equity investment activities on a day-to-day and longer-term basis.[63]

- Finally, SR letter 90-16 lays out the Federal Reserve's supervisory guidelines on asset-backed securities.[64] It requires that a financial institution's board periodically review and approve major policies and procedures and set position limits and control arrangements so that the firm is not overexposed to risk.[65] It also requires that the board of directors receive periodic and timely reports regarding the performance and risks of asset-backed securities.[66] Here again, the letter assigns appropriate responsibilities to the board. Asset-backed securities crammed with millions of subprime mortgage loans played a major role in igniting and fueling the financial crisis, and the need for careful oversight of such activities by any financial institution at the board level is indisputable.

In these cases and others, the SR letters reflect an appropriate division of labor between the board and senior management, and they align with the principle set forth in the Release that the board of directors should be involved in "approving the institution's overall

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59 *See* SR 14-8 *supra* note 58 at 4.
60 *See id.* at 4-5.
61 Bd. of Govs. of the Fed. Reserve System, SR 00-9, Supervisory Guidance on Equity Investment and Merchant Banking Activities Attachment at 4-5 (June 22, 2000).
62 *Id.* at 4-5.
63 *Id.* at 5.
64 SR 90-16, *supra* note 55 at 1.
65 *See* Bd. of Govs. of the Fed. Reserve System, SR 90-16 Attachment 1, Examination Guidelines for Asset Securitization, 13 (May 25, 1990).
66 *See id.* at 2-3, 6.

business strategies and significant policies; understanding the risks the institution faces and having access to information to identify the size and significance of the risks; providing guidance regarding the level of acceptable risk exposures to the institution; and overseeing senior management's implementation of the board-approved business strategies and risk limits."[67] They do not create the expectation that the board will be involved in day-to-day business activities. Accordingly, the intended modifications described generally in the Release are far more likely to curtail the board's important oversight role in a harmful way and diminish its accountability, not provide helpful clarity about that role.

CONCLUSION

We hope you find these comments helpful.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Legal Director & Securities Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
shall@bettermarkets.com
www.bettermarkets.com

[67] Release at 37221.