Davis Polk

February 15, 2018

By electronic submission to regs.comments@federalreserve.gov

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: <u>Comment Letter on the Proposed Guidance on Supervisory Expectation for Boards of Directors (Docket No. OP-1570)</u>

Ladies and Gentlemen:

Davis Polk & Wardwell LLP ("**Davis Polk**") welcomes the opportunity to comment on the notice issued by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") entitled *Proposed Guidance on Supervisory Expectation for Boards of Directors*, published in the Federal Register on August 9, 2017 (the "**Board Proposal**").[1]

We commend the Federal Reserve's Board Proposal and support many of its general principles and core themes, especially its aim to focus boards of directors of Federal Reserve-supervised banking organizations on their core responsibilities and for recognizing that a board's composition, governance structure and practices should reflect such factors as the firm's asset size, complexity, scope of operations and risk profile—in other words, a tailored model rather than a "one size fits all" model. The Federal Reserve's Board Proposal is an encouraging step toward a more rational and effective approach to supervisory expectations for the corporate governance of banking organizations. Nevertheless, we believe that there are certain clarifications and improvements that should be made to the Board Proposal, both to the substantive guidance and to the supervisory processes addressed in the guidance.

The Board Proposal, which reflects the Federal Reserve's multi-year review of the practices of boards of directors, would provide greater clarity regarding, and better distinguish, supervisory expectations for boards of directors and senior management of covered banking organizations. In particular, the Board Proposal has three main parts:

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[1] Federal Reserve, *Proposed Guidance on Supervisory Expectation for Boards of Directors*, 82 Fed. Reg. 37219 (Aug. 9, 2017) [*hereinafter*, Board Proposal].

- The first part is proposed supervisory guidance addressing board effectiveness (the "**BE Guidance**"), which would apply to domestic bank holding companies ("**BHCs**") and savings and loan holding companies ("**SLHCs**") with $50 billion or more in total consolidated assets and to systemically important nonbank financial institutions ("**nonbank SIFIs**").[2] The BE Guidance "would clarify supervisory expectations for boards as distinct from expectations for senior management, and identifies five key attributes of effective boards of directors" that the Federal Reserve would use to assess a firm's board.[3] The guidance would form part of the new proposed large financial institution ("**LFI**") rating assessment system,[4] which was released contemporaneously with the Board Proposal.

- The second part of the Board Proposal would initiate a process by which the Federal Reserve would streamline existing supervisory expectations and regulatory requirements related to boards of directors to ensure alignment with the Federal Reserve's revised supervisory framework and to eliminate redundant, outdated or irrelevant supervisory expectations. In particular, in the first phase, the Federal Reserve proposes to rescind or revise supervisory guidance applicable to boards of directors in existing Supervision and Regulation ("**SR**") letters. The Federal Reserve identifies a preliminary list of SR letters for potential elimination or revision in the Board Proposal. In the second phase, the Federal Reserve would focus on revising applicable Federal Reserve regulations and interagency guidance.

- The third part would clarify the Federal Reserve's supervisory communications to institutions concerning examination and inspection findings requiring corrective action, such as clarifying the board's role with respect to addressing Matters Requiring Attention ("**MRAs**") and Matters Requiring Immediate Attention ("**MRIAs**") (the "**Supervisory Findings Communication Guidance**"). This part of the Board Proposal would apply to all financial institutions supervised by the Federal Reserve, including all BHCs and SLHCs, state member banks, U.S. branches, agencies and IHCs of foreign banking organizations, and nonbank SIFIs.

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[2] The BE Guidance would not apply to U.S. intermediate holding company ("**IHC**") subsidiaries of foreign banking organizations. The Federal Reserve stated that it anticipates proposing board effectiveness guidance for IHCs at a later date. Board Proposal at 37219 & n.1.

[3] *Id.* at 37219-20; *see also id.* at 37224.

[4] Federal Reserve, *Large Financial Institution Rating System*, 82 Fed. Reg. 39049 (Aug. 17, 2017) [*hereinafter*, LFI Proposal].

The Federal Reserve has also proposed supervisory guidance on core principles of effective senior management, the management of business lines, and independent risk management and controls for large financial institutions (the "**Management Proposal**"), which likewise seeks to better distinguish the supervisory expectations of boards from those of senior management.[5] While this comment letter focuses on the Board Proposal, it also addresses certain related issues that arise in the Management Proposal.

Part I of this letter includes our comments on the core themes and other general principles of the Board Proposal. The remainder of this letter focuses on specific aspects of the Board Proposal and is organized as follows: Part II comments on the BE Guidance; Part III proposes clarifications regarding the Supervisory Findings Communication Guidance; and Part IV recommends an approach to implementing the part of the Board Proposal that would rescind or revise existing supervisory expectations and regulatory requirements regarding boards of directors.

I. Introduction and Core Themes

As noted above, we commend many aspects of the Board Proposal. In particular, we support the general principles and core themes of the Board Proposal, as discussed in greater detail below.

A. Focus on Core Responsibilities

We support the primary goal of the Board Proposal—to focus directors on their core responsibilities[6]—which is reflected in all three parts of the Board Proposal. For example, in the preamble to the Board Proposal, the Federal Reserve states that "the proposed BE Guidance better distinguishes the supervisory expectations for boards from those of senior management," and is organized around five attributes that reinforce a board's "effectiveness in meeting its core responsibilities."[7] The Federal Reserve acknowledges that its multi-year review of practices of boards of directors found that "boards often devote a significant amount of time satisfying supervisory expectations that do not directly relate to the board's core responsibilities" and that "[b]oards completing such non-core tasks may do so at the expense of sufficiently focusing on their core responsibilities."[8]

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[5] Federal Reserve, *Proposed Supervisory Guidance*, 83 Fed. Reg. 1351, 1353 (Jan. 11, 2018) [*hereinafter*, Management Proposal].

[6] Board Proposal at 37219.

[7] *Id.* at 37220.

[8] *Id.* at 37219.

Similarly, the Federal Reserve states in the preamble that the initiative to streamline existing expectations and requirements related to board responsibilities would amend SR letters by revising expectations that inappropriately apply to both boards and senior management so that they refer only to senior management.[9] Finally, the Federal Reserve clarifies in the preamble's discussion of the proposed Supervisory Findings Communication Guidance that the role of a board in addressing supervisory findings is to "hold[] senior management accountable" and that the existing supervisory expectations under SR letter 13-13 in many cases inappropriately "led boards of directors to believe they should become directly involved in addressing the MRIA or MRA."[10]

We fully support the Federal Reserve's recognition of the need to "clearly distinguish between a board's roles and responsibilities from those of senior management" to prevent "boards unnecessarily addressing matters that are better suited for senior management."[11] We believe that it is very helpful, for example, for the Federal Reserve to have acknowledged that boards should be focused on assessing a firm's "significant" policies, programs and plans, rather than a broader range of policies and procedures, and that it is senior management's responsibility to implement a firm's strategy and risk tolerance and maintain a firm's risk management and control framework, while it is the board's responsibility to hold senior management accountable for doing so.[12]

B. General Approach Tailored to Firms' Individual Circumstances

We support the proposed BE Guidance's general approach of relying more on broadly applicable governance principles than on narrowly prescriptive expectations. For example, we support the statement in the BE Guidance that "[a]n 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."[13] This approach reflects the reality that firms are different from one another and can evolve over time, such that no one set of specific governance expectations can be made to fit all firms in all scenarios.

To that end, we encourage the Federal Reserve to make it clear that, in applying each of the five key attributes of an effective board, a firm's board should assess the

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[9] *See id.* at 37221.

[10] *Id.* at 37222-23.

[11] *Id.* at 37221.

[12] *Id.* at 37221, 37225.

[13] *Id.* at 37226.

extent to which a particular governance practice or aspect—for example, the granularity of a firm's risk limits, the specific policies and procedures that a board approves, the level of detail it receives from management with respect to a business line, the materiality of the risk management issues the board's risk committee would address with the CRO, and the extent to which the board would engage third-party advisors and consultants—is appropriate for that firm's board based on the board's assessment of the complexity, risk profile and other factors relating to the firm's business and operations. The governing principle should be that the specific board governance practices under each of the key attributes should be tailored to the firm's circumstances.

We also commend the Federal Reserve for taking the opportunity to clarify in the BE Guidance that it "does not supersede or replace any applicable legal, regulatory, or listing requirements" and that "nothing herein is believed to conflict with such requirements."[14] This is an important and welcome development in that it clarifies the Federal Reserve's position that legal, regulatory and listing requirements related to the corporate governance of banking organizations, including state law duties of directors, are in harmony with the board effectiveness expectations of the Federal Reserve as a prudential regulator concerned with the safety and soundness of both individual institutions and the financial system as a whole. While welcome, this clarification and the related principle of avoiding conflicts with existing requirements underscore the importance of avoiding overly prescriptive requirements, consistent with the Federal Reserve's more principle-based approach.

C. Streamlining Existing Guidance

We support the Federal Reserve's effort in the second part of the Board Proposal to streamline and conform existing supervisory expectations by "revising or eliminating unnecessary, redundant, or outdated expectations, as appropriate."[15] We agree with the Federal Reserve's suggestion to eliminate or revise existing supervisory expectations for larger firms and smaller firms and to align them instead with the BE Guidance (subject to the comments we make below on the proposed BE Guidance itself) for larger firms and to align them with SR letter 16-11 (subject to certain corresponding comments on the guidance in SR letter 16-11) for smaller firms.[16] In our view, this would have two important beneficial effects:

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[14] *Id.* at 37224.

[15] *Id.* at 37220.

[16] *Id.* at 37221.

- First, it would ensure consistency between the Board Proposal and guidance related to boards of directors and thus mitigate the risk of confusion on the part of bank examiners as to how they are supposed to implement the Board Proposal, including the BE Guidance, in the face of existing, inconsistent guidance; and

- Second, it would reduce the sheer number of SR letters and, ultimately, regulations and guidance (including in such sources as the Federal Reserve's BHC and commercial bank supervision manuals) addressing multiple aspects of the same basic corporate governance issues, namely, the appropriate role of a board of directors in overseeing and holding accountable a banking organization's senior management.

We believe that regulatory guidance and expectations related to boards of directors should be clear, concise and adaptable—without being overly prescriptive—to the breadth of oversight responsibilities that boards face. At the same time, given the myriad supervisory expectations that have accumulated over decades of Federal Reserve supervision, we believe that it would be enormously helpful to consolidate revised guidance and expectations in as few sources as possible, as discussed in greater detail in Part IV below.

D. Revising Communications of Supervisory Findings

Lastly, we support the objective of the third part of the Board Proposal, namely, to revise guidance on the communication of supervisory findings to direct MRIAs and MRAs to senior management and to direct them to a board of directors only "when the board needs to address its corporate governance responsibilities or when senior management fails to take appropriate remedial action."[17] This change would be consistent with ensuring a proper distinction between the role of directors in overseeing and holding senior management accountable and the role of senior management in actually developing and executing remediation plans and actions.

II. Comments on BE Guidance

We generally support the Federal Reserve's effort to propose guidance that would better distinguish the role of boards from that of senior management and would focus the board more on its core responsibilities. Nevertheless, we propose several specific revisions to the BE Guidance that we believe would help to promote the general principles of the Federal Reserve's Board Proposal.

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[17] *Id.* at 37223; *see also id.* at 37227.

A. Balance Between Core Responsibility for Oversight of Risk Tolerance and Risk Management and Oversight of Financial Performance and Earnings Capacity

In the preamble to the Board Proposal, the Federal Reserve describes the core responsibilities of a banking organization's board of directors as including: (1) guiding the development of the firm's strategy and risk tolerance, (2) overseeing senior management and holding them accountable for effective risk management and compliance, (3) supporting the stature and independence of the firm's independent risk management and internal audit functions, and (4) adopting effective governance practices.[18] The text of the proposed BE Guidance develops these core responsibilities into five "key attributes of an effective board":

1. Set clear, aligned and consistent direction;

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.[19]

The key attributes properly emphasize the importance of the board's focus on risk tolerance and risk management, and as a result there are numerous and repeated references to a firm's risk tolerance, risk limits, risk management, risk profile and assessments of risks. There is no mention, however, of a board's responsibility for financial performance, earnings capacity or the generation of returns on shareholders' capital, which must be seen as a core responsibility of any board. In fact, the proposed BE Guidance never uses any of those terms and makes exactly three mentions of "rewards" or "opportunities."[20] Likewise, the Management Proposal—particularly in its discussion of the core principles of effective senior management and of management of the business lines—is unbalanced in its focus on risk and risk management to the exclusion of financial performance and earnings capacity.[21] It is axiomatic that the concepts of risk tolerance, risk limits and risk management can only make sense in the context of a banking organization seeking to balance its revenue-

[18] *Id.* at 37219.

[19] *Id.* at 37224-26.

[20] *Id.* at 37224-25.

[21] *See* Management Proposal at 1356–59.

generating banking and other financial activities against the costs, including the costs of potential risks, of engaging in those activities.

We do not believe that the Federal Reserve intended to downplay or minimize a board's responsibility for ensuring that the firm operates profitably, generates enough earnings to increase its capital base over time in line with the growth of its business and mix of assets and off-balance sheet exposures, and pays dividends on the common equity and other capital that is the foundation of the firm's ability to conduct its business in a safe and sound manner and its resilience to stressed economic, market or even firm-specific conditions. Boards of directors do not and should not focus on potential risks to the exclusion of potential returns, both of which are highly relevant to the safety and soundness of the organization. Oversight of risk tolerance and risk management does not and should not be the sole focus of an effective board to the exclusion of attention to the firm's financial condition and performance. Strong financial performance enables a banking organization to increase retained earnings and capital, thus contributing to a firm's resilience to risk and stressed conditions. Accordingly, an effective board would appropriately balance its role in overseeing both a firm's financial performance and its risk tolerance and risk management.

The Federal Reserve and other U.S. banking regulators have recognized the importance, from a prudential supervisory perspective, of a board's role in overseeing financial performance. The Federal Reserve Bank of Kansas City has noted in its guidance to bank directors that "[the] primary duties [of bank directors] when it comes to bank earnings are to oversee and understand the bank's business performance and know the key areas that impact bank performance."[22] The Office of the Comptroller of the Currency (the "**OCC**") has likewise acknowledged the importance of this board function as a prudential matter in its publication entitled "Director's Book: Role of Directors in National Banks and Federal Savings Associations," in which the OCC stated that "[s]ound financial performance is a key indicator of the bank's success. The board is responsible for overseeing financial performance and risk reporting."[23]

In view of the importance of financial performance, earnings capacity and sufficient equity capital to the safety and soundness of a banking organization, the Federal Reserve should revise the BE Guidance to strike a better balance and more consistently emphasize that boards have a responsibility to hold management accountable for executing a strategy for the generation of adequate returns, in addition to managing risks, and a responsibility to balance its roles in overseeing financial

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[22] Federal Reserve Bank of Kansas City, Division of Supervision and Risk Management, *Basics for Bank Directors*, 51-52 (Mar. 2016).

[23] OCC, *The Director's Book: Role of Directors for National Banks and Federal Savings Associations*, 37 (July 2016).

performance as well as risk tolerance and risk management. Corresponding revisions should be made to the relevant sections of the Management Proposal to strike a more appropriate balance between management's responsibility to generate earnings and focus on financial performance and its responsibility to implement and manage a firm's risk tolerance, risk limits, and risk management and control framework.

B. Supporting the Stature and Independence of the General Counsel and the Legal Department

The fourth key attribute in the BE Guidance refers to a board's responsibility, through its risk and audit committees, to support the stature and independence of a firm's independent risk management and internal audit functions, with compliance being explicitly covered by the reference to the risk management function.[24] While we fully support the substance of this key attribute, we believe that as currently stated there is a risk of creating an imbalance in the importance within a banking organization of the general counsel and the firm's legal department. The Management Proposal is similarly silent on the importance of a firm having a sufficiently robust legal department with appropriate resources, budget and independence and a general counsel with sufficient stature and authority, instead addressing only risk management, internal audit and compliance functions.[25] Risk management and internal audit clearly have specific roles and responsibilities in a firm's overall risk management framework, with the chief risk officer and the risk management function being responsible for implementing and managing a firm's risk management limits, exposures, controls, policies and procedures, and the chief audit executive and internal audit function being responsible for acting as the third line of defense in any risk management framework.[26] Those roles have also been codified in recent regulations and guidance, including, among others, the Federal Reserve's Regulation YY implementing enhanced prudential standards and the OCC's guidelines establishing heightened standards for large national banks and other OCC-regulated institutions.[27]

A banking organization's general counsel and legal department play a critical role in any firm's management of legal, regulatory and reputational risk. A general

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[24] Board Proposal at 37225-26.

[25] *See, e.g.,* Management Proposal at 1359–60 & n.49 (proposing expectations for the governance, independence and stature of (i) a firm's chief risk officer and chief audit executive, but not its general counsel, and (ii) a firm's independent risk management function, including compliance, but not the legal department).

[26] *See, e.g.*, Institute of Internal Auditors, *IIA Position Paper: The Three Lines of Defense in Effective Risk Management and Control*, 4–5 (Jan. 2013); OCC, *Comptroller's Handbook—Safety and Soundness: Corporate and Risk Governance*, 46–50 (July 2016).

[27] *See* 12 C.F.R. § 252.33; 12 C.F.R. Part 30, Appendix D.

counsel and legal department typically advise on a range of key legal and reputational issues for a banking organization, including compliance with U.S. and, to the extent applicable, foreign banking laws and regulations governing their firm's banking activities, compliance with U.S. and, to the extent applicable, foreign securities and other laws and regulations governing their firm's securities, investment advisory and other non-banking activities, compliance with applicable consumer protection laws and regulations, compliance with antitrust and other competition laws and regulations, and compliance with reporting requirements related to the registration or listing of their firm's securities with the U.S. Securities and Exchange Commission, securities exchanges and any applicable foreign exchanges or securities regulators. A general counsel and legal department typically also manage a firm's ongoing litigation, investigations and enforcement actions. A firm's failure to comply with any of these and numerous other laws and regulations that govern its activities can expose a firm to the risk of significant financial losses, significant operational and reputational risks, the suspension of or restrictions on affected activities, significant monetary fines and penalties, enforcement and supervisory actions, and even the risk of criminal prosecution of the firm or its officers and employees. The consequences on a firm's regulatory status and financial condition can be significant and ultimately affect the firm's ability to operate in a safe and sound manner.

Unlike the risk management and internal audit functions, the legal department should not be viewed as part of any of the lines of defense, but as a critical function that is separate and apart from both a firm's business units and its lines of defense and whose role includes advising the business units and lines of defense on legal, regulatory and reputational risk.[28] Lawyers are also required to be licensed by a state bar and are subject to binding codes of professional responsibility and review and discipline by the various state bar associations. It is understandable, therefore, why the Federal Reserve did not think to, and should not, include any direct regulation of the critical legal function such as one sees for risk management in Regulation YY. By remaining silent on a board's responsibility to support the stature and independence of the firm's general counsel and legal department, however, the Federal Reserve risks creating an erroneous impression and imbalance between the importance of the legal function and that of risk management, compliance and internal audit.

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[28] *See* OCC, *OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations; Final Rule*, 79 Fed. Reg. 54518, 54525 (Sept. 11, 2014) (explaining that the definition of "front line unit" (i.e., the first line of defense) "should not ordinarily include an organizational unit or function that provides legal services to the covered bank," but that "where the General Counsel is responsible for functions that extend beyond legal services . . . examiners will determine whether these functions meet the definition of a front line unit, independent risk management or internal audit") [*hereinafter*, OCC Heightened Standards].

We therefore believe that the fourth key attribute of the BE Guidance should be expanded to include a specific reference to the need for a banking organization's board of directors to ensure that the firm's general counsel has the independence, stature and reporting line within senior management commensurate with that of a chief risk officer or chief audit executive and that the board can also communicate directly with the general counsel to the extent necessary on material legal risk issues. Corresponding revisions should also be made to the Management Proposal.

An effective board should also ensure that the firm's legal department is provided with sufficient staffing and financial resources to allow it to perform its important legal advisory and legal risk management function. Finally, just as we agree that a key attribute of an effective board is its ability to identify instances or decisions where the lack of independence and stature of risk management and internal audit have materially impacted a firm's business deliberations, practice or strategy,[29] we believe that an effective board should also identify whether the lack of independence, stature or resources of a general counsel or legal department may have materially affected a firm's ability to effectively manage its legal, regulatory and reputational risk.

C. Board Self-Assessments Should Remain Driven by Firms' Own Corporate Governance Practices

As part of the fifth key attribute in the BE Guidance, the Federal Reserve observes that "[a]n effective board assesses its strengths and weaknesses, including the performance of the board committees, particularly the risk, audit and other key committees. An effective board adapts its structure and practices to address identified weaknesses or deficiencies, and as the firm's asset size, scope of operations, risk profile, and other characteristics change over time."[30] In its request for comments, the Federal Reserve specifically asks whether (i) boards of firms subject to the BE Guidance should be *required* to perform a self-assessment of their effectiveness and *provide the results of the self-assessment to the Federal Reserve*, and (ii) whether such self-assessments should be used as the primary basis for supervisory evaluations of board effectiveness.[31]

We certainly agree that the boards of many banking organizations, particularly those of publicly traded firms, evaluate their effectiveness through self-assessments as a matter of good corporate governance practice. But we believe that it would defeat the purpose of this laudable practice for the Federal Reserve to convert it into a supervisory requirement that would be used as the primary basis for supervisory

[29] Board Proposal at 37226.

[30] *Id.*

[31] *Id.* at 37223 (request for comment no. 3) (emphasis added).

evaluations of board effectiveness. We recommend that the Federal Reserve continue to permit self-assessments and other methods of self-evaluation to develop and evolve based on the judgment of the firm, its board of directors and its shareholders as to which are the most appropriate methods for the firm in question. The Federal Reserve should not substitute its judgment for what constitutes the most appropriate way of achieving this objective. As a corollary, in order to ensure that board self-assessments continue to develop and function as effective and honest reflections of a board's performance, and are not seen by the boards or firms merely as a means of achieving a particular supervisory rating, the results of such self-assessments should remain confidential and should not be disclosed to the Federal Reserve.

If board self-assessments were to become an explicit requirement or supervisory expectation, we are concerned that firms would be incentivized to develop and converge on a *de facto* standard format or approach that would seek to "check the box" of addressing supervisory expectations, even in the absence of any specific guidance or requirements for what constitutes an acceptable self-assessment. Such a development would undercut the general principle underlying the Board Proposal that no one size fits all firms and, more specifically, the need for boards to maintain the flexibility to tailor their board composition, governance structure and practices to their firms' specific complexity, risk profile and other factors. A *de facto* standard for self-assessments could also conflict with boards' existing practices, which for each firm are specifically tailored to the needs of the particular firm and already subject to market discipline through oversight by shareholders. In any case the purpose of board self-assessments should be to develop the best criteria, most appropriate to the specific firm based on the firm's specific circumstances, including its business and risk profile, against which to measure the board's effectiveness to best serve the firm and the shareholders to which the board owes its fiduciary duties. By requiring boards to conduct such self-assessments for purposes of measuring their performance against supervisory expectations and thereby determining one of the firms' supervisory ratings, the Federal Reserve runs a serious risk of forcing boards and their firms to view the primary purpose of self-assessments as a means to achieve a satisfactory rating based on the Federal Reserve's explicit or implicit criteria. In our view, this would defeat the purpose of self-assessments by substituting supervisory expectations for the best interests of the board, the firm and its shareholders.

We are similarly concerned by the impact that a requirement to disclose board self-assessments to the Federal Reserve may have on the effectiveness and utility of the self-assessments. Boards of directors generally conduct self-assessments in the absence of an existing supervisory expectation or regulatory requirement that they do so because they are a valuable tool to continually improve a board's effectiveness in overseeing management and fulfilling directors' fiduciary duties. This tool is useful in large part because of the trust directors place in one another to express their honest and forthright views of the board's work, including its interaction with management. The starting point for any self-assessment must necessarily be a willingness to self-identify potential weaknesses or improvements in the way a board functions. If the results of a board's self-assessment are required to be disclosed to the Federal Reserve so that they can be taken into account in determining a firm's supervisory rating, there is a risk that the views expressed in the self-assessment will be affected by the potential supervisory consequences. By potentially shifting the focus of self-assessments from the free and honest exchange of views and opinions between board members as to their own effectiveness to a process tied to meeting supervisory expectations, the Federal Reserve risks defeating the purpose of self-assessments—to encourage directors, on their own and as part of their own corporate governance practice, to identify ways in which they could more effectively fulfill their responsibilities.

D. Management of Information Flow and Board Discussions

As part of the second key attribute in the BE Guidance, the Federal Reserve notes that directors of an effective board may seek information about the firm and its activities outside board and committee meetings, including through "outreach to staff other than the Chief Executive Officer (CEO) and his or her direct reports, discussions with senior supervisors, and training on specialized topics."[32] As noted above, one of the stated objectives of the Board Proposal is to better distinguish between supervisory expectations for boards of directors and those for senior and business line management. While it may be entirely appropriate for directors to seek additional information on specific issues by engaging in dialogues with and receiving information from various members of management or employees of the firm, the Federal Reserve should clarify that, consistent with the principle that an effective board should focus on its core responsibilities and not "unnecessarily address[] matters that are better suited for senior management,"[33] the purpose of the key attribute of managing information flow and board discussions should be to allow the board to focus on its core responsibility of overseeing senior management by receiving the information necessary for the board to do so effectively. Its purpose should not be to establish a *de facto* standard under which directors are expected to receive a level of detailed information and develop a level of expertise on a particular issue comparable to the management they are supposed to oversee and hold accountable for managing the firm, and to do so from sources other than the CEO or his or her direct reports.

The Federal Reserve's focus on the management of information flow in this key attribute appears to stem from a stated concern that boards are "inherently disadvantaged given their dependence on senior management for the quality and

[32] *Id.* at 37225.

[33] *Id.* at 37221.

availability of information."[34] Yet information asymmetry between senior management and the board is the unavoidable result of the division of core responsibilities between senior management, who have day-to-day executive responsibilities, and boards, who oversee senior management. The Federal Reserve rightly observes in the very same key attribute that an effective board directs senior management to provide timely and accurate information to the board with the appropriate level of detail and context, and also evaluates information flows and engages with senior management on related improvements.[35]

That description of the board's role in managing and evaluating information flow, and the acknowledgment in the third key attribute of the role the board in general and independent directors in particular play in holding management accountable and being sufficiently empowered to act as a check on management,[36] properly describe how a board may fulfill its responsibility of overseeing management and holding it accountable notwithstanding this information asymmetry. Of course, some issues may well be so complex or so important to a firm that a board may determine to request more detailed information than it would normally receive and to meet directly with subject-matter experts in the firm who are not direct reports of the CEO. We believe, however, that that judgment should be within the discretion of the board based on its own judgment of what it needs to make a well-informed decision and properly oversee management. If the Federal Reserve instead sets as a supervisory expectation that boards may not be viewed as having made sufficiently well-informed decisions without engaging in discussions with firm employees who are not direct reports of the CEO and without receiving specialized training, one of the very purposes of the BE Guidance—to avoid boards being "overwhelmed by the quantity and complexity of information they receive"[37]—will be defeated. We therefore recommend that the BE Guidance avoid prescribing measures that would seek to mitigate this information asymmetry by creating *de facto* expectations that directors should seek access to particular groups of people or sources of information or seek particular training.

E. Substituted Compliance for Intermediate Holding Companies of Foreign Banking Organizations

The proposed BE Guidance would not apply to the U.S. intermediate holding companies ("**IHCs**") of foreign banking organizations ("**FBOs**") established pursuant

[34] *Id.* at 37219.

[35] *Id.* at 37225.

[36] *Id.*

[37] *Id.* at 37219.

to the IHC requirements of Regulation YY.[38] The Federal Reserve requests comment as to how the proposed BE Guidance and refocusing of existing supervisory expectations should be adapted to apply to the boards of IHCs.[39]

We believe the Federal Reserve is right to be sensitive to the difficulties of imposing its own BE Guidance and its own supervisory expectations on what constitutes an effective board on IHCs, which, as wholly-owned holding company subsidiaries of FBOs, may be subject to the FBO's own home-country requirements with respect to supervisory expectations for corporate governance. We therefore recommend that the Federal Reserve consider adopting a substituted compliance approach in applying similar guidance to IHCs of FBOs, to the extent that home-country standards applicable to FBOs cover similar ground. If there are no applicable home-country corporate governance standards or requirements, the expectations for those IHCs should be adapted to the specific circumstances of IHCs. For example, since these IHCs are all wholly-owned subsidiaries of FBOs rather than public companies with their own distinct shareholders, there should not be a supervisory expectation that an IHC board have independent directors or a lead independent director. That determination should be left up to the FBO and IHC in question based on its own assessment of the appropriate corporate governance structure for the IHC. We similarly recommend that the Management Proposal more explicitly defer to the home-country standards or requirements applicable to the U.S. branches or agencies of a foreign bank to avoid creating the risk that an FBO would have to comply with conflicting supervisory expectations or requirements.

III. Comments on Supervisory Findings Communication Guidance

We commend the Federal Reserve's proposal to clarify that a board's role with respect to addressing MRAs and MRIAs is generally to oversee senior management and not to directly remediate MRAs and MRIAs.[40] This clarification is particularly welcome in light of the relatively high degree of time and attention that, in our experience, boards have felt they needed to devote to supervisory findings in recent years.

Consistent with the proposed Supervisory Findings Communication Guidance, we recommend that the Federal Reserve similarly alter the language in supervisory or enforcement actions, such as consent orders, written agreements and memoranda of understanding, to direct responsibility for remediating MRAs and MRIAs to senior management and not to the board. This change would ensure that the wording used by

[38] *Id.* at 37219 & n.1.

[39] *Id.* at 37223 (request for comment no. 1).

[40] *Id.* at 37226.

the Federal Reserve in the Board Proposal, the BE Guidance, the Management Proposal or in any related supervisory or regulatory requirements is consistent with the underlying principle of distinguishing between the role of the board of directors in overseeing senior management and holding it accountable for addressing supervisory findings and that of senior management in making the executive and operational decisions about, and managing the implementation of, the related remediation plan and actions.

The Federal Reserve also specifically requests comment as to whether its proposed guidance in this part of the Board Proposal is clear regarding the division of responsibilities between the board and senior management.[41] We recommend that the Federal Reserve clarify that a board's responsibility for holding senior management accountable does not make a board operationally responsible for implementing remediation actions, as opposed to its normal oversight responsibility for management's actions and performance.

IV. Comments on Proposal to Rescind or Revise Existing Federal Reserve Expectations for Boards of Directors

As noted above, we commend the Federal Reserve for initiating the process of revising or rescinding existing SR letters, and eventually for revising Federal Reserve regulations and interagency guidance, to be more streamlined and consistent with the BE Guidance. The scope and breadth of existing supervisory expectations, regulations and interagency guidance that have accumulated over the years have resulted in a jumbled body of requirements that presents a practical compliance challenge for boards of directors. For example, in our work for clients, we have identified well over 50 different and specific requirements or expectations for a BHC board of directors to review or approve a specific set of policies and procedures, with such requirements or expectations scattered across various regulations, SR letters and sections of the BHC Supervision Manual, among other sources. The initiative to streamline and simplify this guidance is both welcome and overdue.

Without diminishing our general support for this initiative, in the remainder of this Part IV we offer two general recommendations—one substantive and one procedural—for ways to further advance the Federal Reserve's effort to streamline its supervisory expectations and requirements in this area.

[41] *Id.* at 37223 (request for comment no. 5).

A. Substantive Changes to and Fundamental Reorganization of Supervisory Expectations for Boards

The Federal Reserve should use this initiative for revising its existing SR letters, rules and interagency guidance as an opportunity not just to streamline and conform its supervisory expectations for boards of directors, but also to further substantively edit and fundamentally reorganize this body of supervisory expectations.

The Federal Reserve states in the preamble to the Board Proposal that revisions to existing SR letters could take the form of "deleting portions of an SR letter that would include duplicative expectations to those contained in the proposed BE guidance or SR 16-11, or which otherwise are no longer relevant."[42] Although we fully support such revisions, we urge the Federal Reserve to consider a more systematic approach that would consolidate and streamline board governance requirements and make it easier for boards to know what is expected of them.

Specifically, the Federal Reserve should consider removing all topic-specific board and corporate governance expectations found in existing SR letters, rules or interagency guidance and instead consider relying on the key attributes and principles contained in the BE Guidance. The firms subject to the BE Guidance and their boards would determine in their judgment, based on the business, scope of operations and risk profile of the individual firm, how best to apply the BE Guidance to address substantive topic-specific guidance contained in SR letters and elsewhere. We believe this approach would be consistent with the general principle that boards should tailor their corporate governance practices to the circumstances of their firms instead of pursuing a one-size-fits-all approach. If the Federal Reserve nonetheless determines that it is appropriate to retain one or more topic-specific expectations currently documented in SR letters, it should consider consolidating such expectations in a single SR letter or rule devoted specifically to board governance expectations. Going forward, board governance requirements would not be included in topic-specific rules or guidance, but rather would be covered as part of a specific board governance SR letter or other form of guidance document. This alternative approach would make it much easier for boards to understand what is expected of them compared to the current patchwork in which topic-specific SR letters and guidance may or may not contain specific board governance requirements, thus forcing boards and their advisors to monitor and evaluate compliance with multiple sources of such requirements instead of a single, consolidated set of requirements.

For example, the BE Guidance already states the general principle that an "effective board assesses whether the firm's significant policies, programs, and plans

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[42] *Id.* at 37221.

are consistent with the firm's strategy, risk tolerance, and risk management capacity prior to approving them."[43] We believe, as noted above, that a board and firm should be able to determine, based on the particular business operations and risk profile of the firm, which policies, programs and plans are "significant" to that firm and therefore warrant approval by the board or a board committee. If, however, the Federal Reserve continues to provide specific guidance with respect to specific policies, programs and plans that should be approved by the board, under our proposed approach, a dedicated SR letter or rule setting forth each of the topic-specific supervisory expectations applicable to boards would also state the Federal Reserve's supervisory expectations about *which* policies, programs and plans it views as "significant" in this context. We note that the Federal Reserve already partially adopted this approach by stating in the BE Guidance that "[s]ignificant policies, programs and plans include the firm's capital plan, recovery and resolution plans, audit plan, enterprise-wide risk management policies, liquidity risk management policies, compliance risk management program, and incentive compensation and performance management programs."[44] (We do not express a view, however, as to whether, in the case of each firm subject to the BE Guidance, each of the preceding policies, programs and plans would in fact be "significant.")

In short, under this organizational approach, all supervisory expectations applicable to boards would reside in one or two documents, updated by the Federal Reserve from time to time as needed—rather than spread throughout multiple SR letters, rules and interagency guidance.

In addition to this recommended organizational approach, we also recommend that the Federal Reserve expand the scope of its streamlining initiative to include changes to its guidance directed at examiners, such as the BHC Supervision Manual.[45] Portions of this manual include guidance and instructions related to the examination of a board's compliance with supervisory expectations and requirements, which should be updated to reflect the final BE Guidance. The supervision manuals should also be updated to reflect the general principle that boards should have the flexibility to tailor their corporate governance practices to the particular complexity, risk profile, scope of operations and other factors of a firm and that no one practice fits all organizations. In addition, the manuals should reflect the BE Guidance's focus on the core responsibilities of boards and therefore instruct examiners to focus their dialogues with

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[43] *Id.* at 37225.

[44] *Id.*

[45] *See, e.g.*, Federal Reserve, *Bank Holding Company Supervision Manual* (last updated Sept. 2017); Federal Reserve, *Commercial Bank Examination Manual* (last updated Nov. 2017).

directors on issues that are relevant to those responsibilities rather than those of senior management.

Finally, to the extent possible, the Federal Reserve should endeavor to work with other U.S. banking agencies, such as the OCC, to harmonize agency guidance, particularly as large banking organizations often have more than one federal regulator responsible for supervising the boards of different levels of the organization.[46]

B. Procedural Changes in Implementing the Proposed Revisions to Supervisory Expectations

Before implementing changes to these SR Letters, rules or interagency guidance with respect to supervisory expectations for boards, the Federal Reserve should consider three procedural changes:

First, the Federal Reserve should adopt formal or informal procedures to solicit feedback from interested parties, including firms and their boards. Such procedures need not rise to the level of a formal notice of proposed rulemaking; the feedback could be obtained through a less formal consultation or supervisory process if appropriate. In either case, it is important for the Federal Reserve to solicit input from affected institutions to ensure that the supervisory expectations ultimately set forth in the revised and streamlined SR letters, rules or other forms of guidance are consistent with the final BE Guidance.

Second, material increases in board expectations should apply prospectively only. Specifically, the Federal Reserve should give boards a reasonable period to comply with any heightened board expectations before any failure to do so results in any adverse effect on supervisory ratings or in any other adverse supervisory consequences. This approach will make the supervisory process more consistent with fundamental principles of due process and the rule of law, avoiding the retroactive definition or application of binding supervisory expectations.

Third, the Federal Reserve should clarify how it intends to implement its revised supervisory expectations in the Board Proposal during a transition period. Specifically, there will likely be a period during which the BE Guidance is finalized and effective, but before the existing SR letters or other regulations or guidance, including interagency guidance, are revised. The Federal Reserve should clarify in the BE Guidance that during such a transition period, it will not take any supervisory action against a banking organization that meets the standards described in the BE

[46] For example, the OCC has articulated its own expectations for certain aspects of the corporate governance of large national banks in the OCC Heightened Standards. *See* 12 C.F.R. Part 30, Appendix D.

Guidance for failure to meet pre-existing, but not yet revised or rescinded, supervisory expectations or requirements that are inconsistent with the BE Guidance.

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Davis Polk thanks the Federal Reserve for its consideration of our comments. If you have any questions, please do not hesitate to contact Luigi L. De Ghenghi at (212) 450-4296, Randall D. Guynn at (212) 450-4239 or Margaret E. Tahyar at (212) 450-4379.

Yours sincerely,

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By: ______________________

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