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Directors' Duty to Monitor: Experience in the Banking Sector—Part II

*Paul L. Lee**

This article analyzes the statutory, regulatory, and supervisory requirements for director monitoring of banks and bank holding companies. In the first part of this article, the author analyzed the monitoring duties of the directors of a bank holding company under Delaware corporate law. This part of the article discusses the regulatory and supervisory approaches that have been adopted by the bank regulatory authorities to board oversight at the level of both the bank and the bank holding company.

This article analyzes the statutory, regulatory and supervisory requirements for director monitoring of banks and bank holding companies. Part I of this article discussed the monitoring duty of directors of bank holding companies under Delaware corporate law. Delaware corporate law imposes two basic fiduciary duties on a director: a duty of care and a duty of loyalty.[1] The duty of care requires a director to administer the affairs of the corporation in a manner "ordinarily careful and prudent men [and women] would use in similar circumstances."[2] The duty of loyalty requires that a director put the interests of the corporation above his or her personal interest and take reasonable action to ensure that "the corporation is not deprived of any advantage to which it is entitled."[3] Under Delaware law, the duty of a director to exercise appropriate oversight over the operations of a corporation is subsumed within the duty of loyalty.[4] These fiduciary duties are owed by the directors to the corporation and the shareholders of the corporation. Under the standard view of these fiduciary duties, the exclusive focus of directors should be on maximizing shareholder

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[1] *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006); *Mills Acquisition Co. v. Macmillan*, 559 A.2d 1261, 1280 (Del. 1989). For a detailed discussion of the duty of care and the duty of loyalty as construed by Delaware courts, see 1 R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations and Business Organizations §§ 4.14–4.16 (3d ed., 1998).

[2] *Graham v. Allis-Chambers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

[3] *Mills Acquisition Co.*, 559 A.2d at 1280.

[4] *Stone*, 911 A.2d at 369–370 (2006).

value.[5] The directors of a bank occupy a fiduciary position similar to that of the directors of other corporations. They owe fiduciary duties of care and loyalty to the bank and its shareholders.[6] The Office of the Comptroller of the Currency (the "OCC"), the chartering authority for national banks, has articulated the fiduciary duties of care and loyalty of directors of a national bank in terms that are similar to the articulation of such duties under general corporate law.[7] As a regulatory and supervisory matter, however, the bank regulators have imposed significant additional responsibilities on the directors of banks and bank holding companies.[8] Part II of this article focuses on these regulatory and

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[5] *See, e.g.*, John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 1 (2014) ("The generally accepted framework for analyzing corporate law and governance implies that those running a corporation should seek to maximize the value of shareholders' claims, as measured by the stock price."); Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 FRBNY ECON. POL'Y REV. 91, 92 (2003) ("The defining principle of American corporate governance is that an implicit term of the contract between shareholders and the firm is that the duty of managers and directors is to maximize firm value for shareholders."). Some commentators reject the premise of shareholder value maximization. For a full-throated critique of the theory of shareholder value maximization, see Lynn Stout: THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 3 (2012) ("[S]hareholder value ideology is just that—an ideology, not a legal requirement or a practical necessity of modern business life. United States corporate law does not, and never has, required directors of public corporations to maximize either share value or shareholder value.").

[6] *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK: ROLE OF DIRECTORS FOR NATIONAL BANKS AND FEDERAL SAVINGS ASSOCIATIONS 21(JULY 2016) [hereinafter DIRECTOR'S BOOK] ("Directors' activities are governed by common law fiduciary legal principles, which impose two duties—the duty of care and the duty of loyalty.").

State corporate and banking laws establish comparable fiduciary duties for directors of state-chartered banks. For a survey of state corporate and banking laws relating to director duties, see DAVID BARIS, AMER. ASS'N OF BANK DIRECTORS, BANK DIRECTOR STANDARDS OF CARE AND PROTECTIONS: A FIFTY-STATE SURVEY (2013).

[7] *See* DIRECTOR'S BOOK, *supra* note 6, at 22:

> The duty of care requires that directors act in good faith, with the level of care that ordinarily prudent persons would exercise in similar circumstances and in a manner that the directors reasonably believe is in the bank's best interests. The duty of care requires directors to acquire sufficient knowledge of the material facts related to proposed activities or transactions, thoroughly examine all information available to them, and actively participate in decision making. The duty of loyalty requires that directors exercise their powers in the best interests of the bank and its shareholders rather than in the directors' own self-interest or in the interest of any other person.

[8] The DIRECTOR'S BOOK provides detailed guidance on the additional responsibilities of a director of a national bank. For example, the DIRECTORS' BOOK lists seventeen responsibilities for the board of a national bank, ranging from the generality of "providing effective oversight" to the

supervisory requirements.

IS CORPORATE GOVERNANCE DIFFERENT FOR BANKS?

Observers have regularly asked whether corporate governance for banks is (or should be) different from governance for other corporations.[9] The resounding answer from the bank regulatory authorities is that bank governance is (and should be) different from the governance of other corporations because of the special credit and liquidity intermediary functions performed by banks.[10] These special intermediary functions have historically led to a highly regulated environment for banking institutions, which in turn has directly influenced governance processes.[11] The Board of Governors of the Federal Reserve System (the "Federal Reserve Board") maintains that the directors of banks are

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specificity of "ensuring the bank maintains an effective [Bank Secrecy Act/Anti-Money Laundering] control structure." *Id.* at 18. The Director's Book as reissued in 2016 represents a more comprehensive, focused, and detailed presentation of the regulatory responsibilities of the directors of a national bank than the 2010 edition of the Director's Book. *See* The Director's Book: The Role of a National Bank Director (Oct. 2010) [hereinafter 2010 Director's Book]. Another OCC publication, Detecting Red Flags in Board Reports: A Guide for Directors (2004), provides extensive guidance to directors on the range of reports that directors should receive from management on legal and business risks and on the questions that directors should pose to management on these reports. An OCC regulation states that directors "should refer to OCC published guidance for additional information regarding responsibilities of directors." 12 C.F.R. § 7.2010 (2016).

[9] *See, e.g.*, Renee Adams & Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies?*, 9 FRBNY Econ. Pol'y Rev. 123 (2003); Macey & O'Hara, *supra* note 5. *See also* Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 Case W. Res. L. Rev. 1 (1996).

[10] *See, e.g.*, Federal Reserve Board Governor Daniel K. Tarullo, Corporate Governance and Prudential Regulation, Speech at the Association of American Law Schools 2014 Midyear Meeting (June 9, 2014) ("[I]t has long been recognized that the unique features of deposit-taking financial institutions raise the question whether generally applicable corporate law and governance principles are adequate."); 2010 Director's Book, *supra* note 8, at 1 ("National banks, like other corporate organizations, have shareholders who elect boards of directors. Bank directors face unique challenges, however, because banks differ from other corporations. Although banks, like other corporations, use their capital to support their activities, most of the funds banks put at risk belong to others, primarily depositors.").

[11] *See, e.g.*, Michael E. Murphy, *Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension*, 36 Del. J. Corp. L. 121, 124 (2011) ("Banking is a matter of special public interest because the credit and liquidity provided by banks has a pervasive importance to all sectors of the economy."); Michael P. Malloy, Principles of Bank Regulation § 1.1 at 1–2 (3d ed. 2011) ("Banking is a regulated industry. This obvious fact creates legal issues that do not exist for other business enterprises . . . . Each step in the corporate and business life of [banking] entities is subject to regulation.").

responsible for safeguarding the interests not only of shareholders, but also of depositors and other creditors.[12] The OCC has likewise asserted that directors of a national bank are "accountable" as a governance matter "not only to their shareholders and depositors but also to their regulators."[13] The Federal Deposit Insurance Corporation (the "FDIC") too has cited the duties of officers and directors as being owed both to the shareholders and creditors of a bank.[14] As a corporate law matter, a director of a bank or bank holding company may have

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[12] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, COMMERCIAL BANK EXAMINATION MANUAL [hereinafter COMMERCIAL BANK EXAMINATION MANUAL], § 5000.1 at 1 (2013). *See* Hamid Mehran, Alan Morrison & Joel Shapiro, Corporate Governance and Banks: What Have We Learned from the Financial Crisis, Federal Reserve Bank of New York Staff Report No. 502 (June 2011) at 3 ("Beyond the shareholders, the stakeholders in a bank include debtholders, the majority of which are the depositors and the holders of subordinated debt. The deposit insurance authority also has an interest in the bank's health, as its insurance will be called upon in the case of insolvency. Inasmuch as a bank's insolvency has negative consequences for the financial system as a whole (certainly more relevant for larger institutions) and these externalities need to be regulated, bailed out, or both at a sizable cost to taxpayers, the government is also a stakeholder in the bank."). *See also* BASEL COMMITTEE ON BANKING SUPERVISION, GUIDELINES: CORPORATE GOVERNANCE PRINCIPLES FOR BANKS 3 (2015) ("The primary objective of corporate governance should be safeguarding stakeholders' interest in conformity with public interest on a sustainable basis. Among stakeholders, particularly with respect to retail banks, shareholders' interest would be secondary to depositors' interest."); BASEL COMMITTEE ON BANKING SUPERVISION, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE 5 (2010) ("[I]n addition to their responsibilities to shareholders, banks also have a responsibility to their depositors and to other recognized stakeholders. The legal and regulatory system in a country determines the formal responsibilities a bank has to its shareholders, depositors and other relevant stakeholders.").

[13] 2010 DIRECTOR'S BOOK, *supra* note 8, at 1. The DIRECTOR'S BOOK as reissued in 2016 revised this language to read as follows: "The board is accountable to shareholders, regulators, and other stakeholders." DIRECTOR'S BOOK, *supra* note 6, at 11. In the preface to the 2010 DIRECTOR'S BOOK, the OCC also asserted that "directors have certain fiduciary responsibilities to the bank's shareholders, depositors, regulators, and communities it serves." *Id.* (Preface). This language does not appear in the reissued DIRECTOR'S BOOK. *See also* OFFICE OF COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK: MANAGEMENT AND BOARD PROCESSES, § 502 at 1 (1998) (rescinded July 2016) ("Bank directors have a fiduciary duty to shareholders and depositors"). The use of the word "fiduciary" in these sources to describe the responsibilities of directors to depositors and other parties appears to be a mischaracterization of the nature of those responsibilities, which are regulatory in nature and not common law fiduciary responsibilities. The revisions made in the DIRECTOR'S BOOK are presumably intended to reflect the distinction between fiduciary duties and regulatory duties.

[14] Federal Deposit Insurance Corporation, Statement Concerning the Responsibilities of Bank Directors and Officers (1992), *available at* https://www.fdic.gov/regulations/laws/rules/5000-3300.html (discussing the duties of loyalty and care and stating that the "FDIC will not bring civil suits against directors and officers who fulfill their responsibilities, including the duties of loyalty and care, and who make reasonable business judgments on a fully informed basis and after proper deliberation").

a fiduciary duty only to shareholders (or to depositors or other creditors as and if the organization approaches insolvency), but as a regulatory and supervisory matter, a director of a bank or bank holding company has additional duties that are applicable in the ordinary course of business of the bank or bank holding company.

Various provisions in federal banking law impose direct responsibilities on directors of a national bank (or a federally insured state-chartered bank).[15] Based on various provisions in federal banking law, the federal bank regulators have adopted an extensive body of regulations and supervisory guidance for the governance of banks and bank holding companies. The OCC Director's Book indicates that "[b]oth the board and management should ensure that the bank is operating in a safe and sound manner and complying with laws and regulations."[16] The OCC Director's Book likewise indicates that in the context of a holding company structure, the "primary duty of the subsidiary bank's board of directors is to ensure the bank operates in a safe and sound manner."[17] Because of the additional statutory, regulatory and supervisory requirements imposed on the directors of a bank, the exclusive focus of the directors cannot be on maximization of shareholder value (as would normally be the case under general corporate law). As a statutory, regulatory and supervisory matter, the directors of a bank must also take into account the interests of other stakeholders, such as depositors and other creditors, under the general rubric of "ensuring" the safety and soundness of the bank.

THE FIDUCIARY DUTY OF BANK DIRECTORS

Some observers have argued that the directors of banks and bank holding companies should be held to a higher standard of care than the directors of other corporations.[18] Two academic observers writing in 2003 in the Federal

[15] The 2010 Director's Book provides a partial listing of the provisions in federal law that impose duties on directors of a national bank. *See* 2010 Director's Book, *supra* note 8, at 80–91. The Federal Reserve Bank of Kansas City has also published a booklet, describing the role and responsibilities of the directors of banks and listing some of the provisions in federal law that impose duties on the directors of banks. *See* The Federal Reserve Bank of Kansas City, Basics for Bank Directors (2010). *See also* The Federal Reserve Bank of Atlanta, The Director's Primer: A Guide to Management Oversight and Bank Regulation (3rd ed. 2002) for an additional discussion of the responsibilities imposed on bank directors by federal laws and regulations.

[16] Director's Book, *supra* note 6, at 11.

[17] *Id.* at 28.

[18] *See, e.g.*, Macey & O'Hara, *supra* note 5, at 102; McCoy, *supra* note 8, at 1.

Reserve Bank of New York publication, the *Economic Policy Review*, argued that bank directors should owe fiduciary duties to fixed claimants as well as to equity claimants.[19] These observers cited both legal and policy arguments for holding directors of banks to a "broader, if not higher," standard of care.[20] As a legal matter, they cited the history of prior case law that in some instances appeared to hold that directors of banks were subject to a higher standard of care than the directors of other corporations.[21] As a policy matter, these observers argued that the structure of a bank's balance sheet, including its highly leveraged condition and the mismatch in the term structure and liquidity of its assets and liabilities, supported the idea of expanding the scope of a bank director's fiduciary duty to include fixed claimants.[22] These observers envisioned that the expanded duty would come into play in two fiduciary contexts. The first context would be when the directors are making a business decision; in this context the directors would be required as a fiduciary matter to consider the impact of the decision on fixed claimants and not just equity claimants.[23] The second context would be in the monitoring of a bank's operations. These observers asserted that the *Caremark* standard of liability for the duty of monitoring, namely, a sustained or systematic failure to monitor, was too low as applied to the banking industry.[24] They proposed that there should be an inquiry into why the directors were unaware of the activities that led to a loss, as, for example, in the *Caremark* case, and that liability for directors should attach where a failure to construct and maintain an adequate reporting system was the reason for the ignorance. They further asserted that bank directors should not be able to eliminate their personal liability through the use of exculpatory charter provisions.[25] In effect, these observers were arguing for a broader *and* higher standard of care for bank directors.

These two observers returned to the subject of bank governance in 2016 with

[19] Macey & O'Hara, *supra* note 5, at 102.

[20] *Id.*

[21] *Id.* at 99–102. *See* McCoy, *supra* note 9, at 22–55 for a detailed discussion of the history of nineteenth and early twentieth century case law dealing with the standard of care applicable to the directors of banks. The history of the nineteenth and early twentieth century case law on bank director liability has been described by another commentator as "long, meandering, and, in the end, conflicting." *See* Paul L. Lee, *Risk Management and the Role of the Board of Directors: Regulatory Expectations and Shareholder Actions*, 125 Banking L. J. 679, 697 (2008).

[22] Macey & O'Hara, *supra* 5, at 97–98.

[23] *Id.* at 102.

[24] *Id.* at 102–103.

[25] *Id.* at 103.

a new proposal to heighten the standards for bank directors. As with their earlier proposal, these observers published their new proposal in the Federal Reserve Bank of New York *Economic Policy Review*.[26] Their new proposal calls for a "banking expert" requirement for each member of the risk committee of a bank board akin to the "financial expert" requirement for audit committees contained in the Sarbanes-Oxley Act. Their proposal also calls for a "bank literacy" requirement for the other members of a bank board. In the words of these observers, "bank directors should meet professional standards, as opposed to the amateur standards that apply to other corporate directors."[27] Of the general standards applicable to corporate directors, these observers say:

> Put simply, directors of most U.S. corporations are held to the same negligence standard as people participating in any amateur activity, such as recreational golf or pleasure driving.[28]

By imposing professional qualification standards on the directors of a risk committee, these observers hope to hold at least these directors to the higher standards generally applicable to professionals.[29]

In support of these new "qualification" requirements for bank directors, the observers cite "myriad" problems connected with bank governance. One such problem is increased complexity, particularly at large banking institutions.[30] The proposed "qualification" requirements are presumably designed to help in meeting the governance challenges presented by what has proven to be the stubborn circumstance of complexity in the banking system. But the observers appear to attribute even greater weight to another governance challenge that is unrelated to the proposal for qualification requirements for bank directors. These observers discuss at length the problems presented by the dual board

[26] Jonathan Macey & Maureen O'Hara, *Bank Corporate Governance: A Proposal for the Post-Crisis World*, 22 FRBNY Econ. Pol'y Rev. 85 (2016).

[27] *Id.* at 86.

[28] *Id.* at 100.

[29] *Id.* at 86. Delaware courts and commentators seem generally disinclined to hold directors with special expertise to a higher standard of care than other directors. *See, e.g.*, *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 128 n.63 (2009) ("Directors with special expertise are not held to a higher standard of care in the oversight context simply because of their status as an expert."). *See also* E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992–2004?*, 153 U.Pa. L. Rev. 1399, 1446 (2005) ("It would be a perversity of corporate governance goals, in my view, for the Delaware courts to announce a general rule that a director with special expertise is more exposed to liability than other directors solely because of her *status* as an expert.").

[30] *Id.* at 86–90.

structure at the bank level and the holding company level.[31] They perceive an "apparent deep inconsistency" between the fiduciary obligations of bank and bank holding company directors to maximize shareholder returns and their statutory and regulatory obligations to promote the safety and soundness of the bank.[32] In their view, this inconsistency is most apparent at the holding company level where the directors "are pulled in opposite directions" by the rules that govern their behavior.[33] They maintain that as a matter of corporate law, the directors of a bank holding company are required to maximize shareholder value "even if doing so causes the company to assume considerable risk."[34] On the other hand, they note that as a regulatory and supervisory matter, the directors of a bank holding company are expected to focus primarily on the safety and soundness of the bank subsidiary.

Regulatory observers have noted this same tension. Two regulatory observers, also writing in the 2003 issue of the *Economic Policy Review*, noted that although the boards of bank holding companies were assigned the same legal responsibilities as the boards of other corporations, the bank regulators had placed additional requirements on bank boards, particularly with respect to safety and soundness. These regulatory observers noted the potential for conflict between corporate law objectives and regulatory objectives:

> It is important to realize that the objectives of regulators and those of banking firms may not coincide, which could impact the governance, and in turn the conduct, of the firm. In theory, there is a conflict between the objectives of regulators—safety and soundness—and those of shareholders—value maximization. When a conflict exists between value maximization and the need to support prudent operations, regulators expect boards to balance these concerns effectively, by ensuring that bank performance as well as safety and soundness are taken into account.[35]

Although this conflict is perhaps most apparent at the level of the holding company, it exists at the level of the bank as well.[36] At each level the initial

[31] *Id.* at 90–94.

[32] *Id.* at 93–94.

[33] *Id.* at 93.

[34] *Id.*

[35] Adams & Mehran, *supra* note 9, at 136 n.5.

[36] For a discussion of the conflicts that the directors of a bank controlled by a bank holding company may face, see Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L. J. 287 (1996). Research has suggested that for large complex banking institutions there may

answer is the same—the directors must seek to balance the concerns of bank performance with concerns for safety and soundness. However, unlike the analysis under the business judgment rule, which would defer to a good faith decision-making process by a board, if the bank regulators disagree with the balance struck by the board, they can through suasion or, if necessary, administrative action require the board and the management to change the balance. In effect, regulatory and supervisory requirements will "trump" the shareholder maximization norm of corporate law.[37] This has long been the case at the bank level where the chartering authority (the OCC in the case of a national bank and a state banking authority in the case of a state-chartered bank) is also the principal regulator of the bank.

THE FIDUCIARY DUTY OF BANK HOLDING COMPANY DIRECTORS

The potential for conflict between maximizing value (or at least short-term value) for shareholders and promoting the safety and soundness of bank subsidiaries has also existed at the holding company level since the inception of the holding company ownership form and the enactment of the Bank Holding Company Act of 1956 (the "BHCA").[38] In administering the BHCA, the Federal Reserve Board has long maintained that a bank holding company has a primary duty to promote the safety and soundness of its bank subsidiaries and its own overall safety and soundness. The Federal Reserve Board has posited that a bank holding company stands in a special relationship to its bank

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be advantages to constructing boards at the holding company and the major bank subsidiaries with a significant overlap of membership. *See* Renée Adams & Hamid Mehran, *Bank Board Structure and Performance: Evidence for Large Bank Holding Companies*, 21 J. FIN. INTERMEDIATION 243, 246 (2012) ("we find that when complexity increases, firm performance improves when [bank holding companies] have more of their directors sitting on subsidiary boards"). As the Clearing House Association has noted, there are varying models for the composition of the boards for a bank subsidiary and its holding company, including the extent of overlapping membership. *See* The CLEARING HOUSE, GUIDING PRINCIPLES FOR ENHANCING U.S. BANKING ORGANIZATION CORPORATE GOVERNANCE 16–17 (2015) [hereinafter CLEARING HOUSE GUIDING PRINCIPLES]. The Clearing House Association has also noted the obligations of directors who serve in a dual directorship capacity:

> The directors of the subsidiary are obligated to manage the affairs of the subsidiary consistent with their regulatory obligations, their duties to the subsidiary as a legal entity and their duties to the parent company as a shareholder. These duties also apply in a dual-directorship context.

Id. at 17 n. 47.

[37] Macey & O'Hara, *supra* note 26, at 93.

[38] 12 U.S.C. §§ 1841–1852 (2014).

subsidiary. This special relationship is based on the theory that a holding company "derives certain benefits at the corporate level . . . from the ownership of an institution that can issue federally insured deposits and has access to Federal Reserve credit."[39] The Federal Reserve Board has noted as well that the federal safety net supporting bank operations reflects the "critical fiduciary responsibilities" of depository institutions as custodians of depositors' funds and the strategic role of depository institutions as operators of the payments system.[40] Thus, the privilege for a holding company in owning or controlling a bank comes at the price of accepting significant regulatory restrictions not only on the operation of the bank subsidiary, but also on the holding company itself. The safety and soundness requirements applicable to the directors of a bank are in effect transposed to the directors of a bank holding company as well.

The special relationship that exists between a bank holding company and its bank subsidiary is evidenced in federal banking law. For example, the Federal Reserve Board is authorized to bring cease and desist orders and other administrative actions against a bank holding company and its officers and directors for engaging in unsound or unsound practices in the conduct of its bank subsidiary.[41] The special relationship that exists between a bank holding company and its bank subsidiary is further exemplified in the source-of-strength doctrine that has long been asserted by the Federal Reserve Board and that has recently been confirmed and codified into law in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[42]

The Federal Reserve Board added a source-of-strength requirement to Regulation Y, the regulation governing bank holding companies, in 1984 in the form of section 225.4(a)(1). Section 225.4(a)(1) of Regulation Y simply, if indistinctly, provides that a "bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."[43] In proposing the addition of

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[39] Policy Statement; Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707 (April 30, 1987).

[40] *Id.*

[41] 12 U.S.C. § 1818(b)(1) & (3) (2014).

[42] Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376, 1616 (2010), § 616(d) (codified at 12 U.S.C. § 1830o-1). For a detailed discussion of the history of the source-of-strength doctrine and the implications of its codification in the Dodd-Frank Act, see Paul L. Lee, *The Source-of-Strength Doctrine: Revered and Revisited*—Part I, 129 BANKING L. J. 771 (2012) & Part II, 129 BANKING L. J. 867 (2012).

[43] 12 C.F.R. § 225.4(a)(1) (2016).

section 225.4(a)(1) to Regulation Y, the Federal Reserve Board explained that section 225.4(a)(1) was intended to codify the policy that a bank holding company should serve as a source of strength for its bank subsidiaries and should conduct its bank and nonbank operations in accordance with sound banking practice.[44] The source-of-strength doctrine thus rests on two strands of thought. The first strand as noted above is that a holding company derives certain benefits from owning a bank and that accordingly a holding company is required as a regulatory matter to provide financial (and managerial) support to its bank subsidiary, if the bank subsidiary is in weakened or failing condition. Under the view of the Federal Reserve Board, a bank holding company must be prepared to make capital contributions to a failing bank subsidiary even if it is clear that the capital contributions may not forestall the failure of the bank subsidiary.[45] At least one court has concluded that compliance by a holding company with a demand from the Federal Reserve Board to contribute capital to a failing bank subsidiary based on a source-of-strength theory would amount to a waste of corporate assets in violation of the holding company's duty to its shareholders.[46] The statutory codification of a source-of-strength requirement in the Dodd-Frank Act may now moot the issue of a possible corporate waste claim under state corporate law. In any event, the financial demands of the source-of-strength doctrine reflect a significant qualification on traditional notions of corporate insulation and corporate (and director) responsibility.

The second strand of thought in the source-of-strength doctrine is that a bank holding company should not operate in an unsafe or unsound manner. This strand of thought flows from the recognition that a holding company operating in an unsafe or unsound manner may not be able to supply financial support to its bank subsidiary and the further recognition that the unsafe or unsound operation of a holding company or its nonbank subsidiaries may actually cause financial and reputational harm to operations of the affiliated bank subsidiary. This concern is addressed in section 5(e) of the BHCA and in section 225.4(a)(2) of Regulation Y, which authorize the Federal Reserve Board to require a bank holding company to terminate the activities in a nonbank subsidiary that constitute a serious risk to the safety and soundness of an affiliated bank subsidiary or even to terminate ownership of the nonbank

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[44] 48 Fed. Reg. 23,520, 23,523 (proposed May 25, 1983).

[45] 52 Fed. Reg. at 15,707.

[46] *MCorp Financial v. Board of Governors of the Federal Reserve System*, 900 F.2d 852 (5th Cir. 1990), *aff'd in part, rev'd in part, Board of Governors of the Federal Reserve System v. MCorp Financial*, 502 U.S. 32 (1991).

subsidiary.[47] Under section 225.4(a)(1) & (2) of Regulation Y, the unsafe or unsound operation of either a bank subsidiary or a nonbank subsidiary would provide a basis for regulatory action against the holding company and potentially its directors.

The essence of the regulatory constraints on a bank holding company (and its directors) under federal banking law is that the bank holding company is required to conduct its operations, including the operations of its bank subsidiary, in a safe and sound manner. Maximizing the potential for shareholder value of the holding company must be balanced against the potential for adverse effects on the bank subsidiary. For directors of most corporations this balancing would be done under the protection of the business judgment rule. For directors of bank holding companies and their bank subsidiaries, this balancing will first have to pass through the filter of numerous regulations and extensive supervisory guidance that reflect the judgment of the regulators on what may be considered an inappropriate or undue risk and hence an unsafe or unsound practice.[48]

A HEIGHTENED FIDUCIARY DUTY FOR DIRECTORS OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

As noted above, the financial crisis has led some academic observers to suggest that the fiduciary duties of directors of banks and bank holding companies should be expanded. In the vein of the earlier academic observers, two other academic observers have proposed a heightened fiduciary duty specifically for directors of systemically important financial institutions.[49] These academic observers propose that there should be a simple negligence standard (without the protection of the business judgment rule) for director liability in the event of a "significant" loss by a systemically important financial institution.[50] In aid of this heightened standard, they propose a prohibition on the use of exculpation or insurance provisions in the charters of such

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[47] 12 U.S.C. § 1844(e)(1); 12 C.F.R. § 225.4(a)(2).

[48] The 2010 Director's Book described the calculus facing bank directors as follows:

> The OCC recognizes that banking is a business of assuming risks in order to earn profits. Risk levels, however, must be appropriately managed. A bank's safety and soundness are contingent upon effectively managing its risk exposures. Some transactions or activities may expose a particular bank to a level of risk so great that its board may reasonably conclude that no amount of sound risk management can effectively control it.

2010 Director's Book, *supra* note 8, at 10.

[49] Armour & Gordon, *supra* note 5, at 39.

[50] *Id.* at 64.

institutions with respect to liability for such a loss.[51] The observers intend their proposal to serve as a complement to, and not a substitute for, the enhanced regulatory measures that the bank regulators have recently adopted for systemically important financial institutions. Their proposal would nonetheless overturn fundamental protections provided by corporate statutes and judicial decisions, protections that are perceived by many other observers as necessary to attracting qualified directors.[52]

These observers base their proposal on a theory as to the supposed risk preference of an important category of shareholders. The observers posit that it is not in the interest of institutional shareholders pursuing a diversified portfolio approach to investment to have the management and board of a systemically important financial firm pursue maximization of share value because the failure of a systemically important firm would adversely affect not only the value of their investment in that firm, but also the value of their nominally diversified investments in other firms.[53] On this theory, "diversified investors should not want managers to single-mindedly maximize share prices" in their investments in systemically important financial firms.[54] Rather, their analysis suggests that "when a firm's actions affect *systemic risk*, the conventional wisdom [on maximization of shareholder value] is reversed: diversified shareholders want managers to take *less* risk."[55] They also assert that because

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[51] *Id.* at 68.

[52] *See, e.g.*, AMERICAN BAR ASSOCIATION, CORPORATE LAWS COMMITTEE, MODEL BUSINESS CORPORATION ACT, OFFICIAL TEXT WITH OFFICIAL COMMENTS AND STATUTORY CROSS-REFERENCES REVISED THROUGH DECEMBER 2010, § 2.02 Official Comment 3.I ("Developments in the mid- and late 1980s highlighted the need to permit reasonable protection of directors from exposure to personal liability, in addition to indemnification, so that directors would not be discouraged from fully and freely carrying out their duties, including responsible entrepreneurial risk-taking. These developments included increased costs and reduced availability of director and officer liability insurance, the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (1985), and the resulting reluctance of qualified individuals to serve as directors.").

[53] Armour & Gordon, *supra* note 5, at 39 ("if the failure of one [systemically important] firm's projects may impose costs on other firms generally then this increases the correlation of investors' returns, and consequently the undiversifiable portion of their risk").

[54] *Id.* at 39. Stated in the converse, "a system in which shareholder value is interpreted as share price maximization is *not* aligning managers' interests with those of diversified shareholders, at least as regards systemic risks." *Id.*

[55] *Id.* For a different analysis of the likely preference of institutional investors, see Hamid Mehran & Lindsay Mollineaux, Corporate Governance of Financial Institutions, Federal Reserve Bank of New York Staff Report No. 539 at 16–17 (2012) ("Investors are diversified, and failure is firm-specific. In an effort to boost their overall portfolio returns, investors may even prefer that some firms within their portfolio use a high-risk, high-return business strategy, as long as the

maximization of share value "generates particularly pernicious incentives as regards systemic harms," traditional corporate governance mechanisms (such as the business judgment rule) encouraging the goal of share value maximization should be "relaxed" for large financial firms.[56]

Based on this theory, these observers construct a schema for board oversight of systemically important financial companies. The schema rests on an enhancement of three elements in existing governance theory. First, the observers propose that management should have a duty "to address the conflicts of interest imbedded in high-powered performance incentives by obtaining board-level review of risk-taking that may give rise to systemic harms, effectuated through a risk-committee process, akin to a 'special committee' process in other areas of significant conflict."[57] This first element reflects the observers' concern with "compensation mechanisms that governance theory has generally embraced—high-powered incentives to overcome managerial risk-aversion."[58] The observers conclude that the executive compensation practices at systemically important financial firms provided strong incentives for managers to assume excessive risk and to impose systemic externalities on the larger financial system in the run-up to the financial crisis.[59] To address these concerns

investor is hedged against idiosyncratic failures. . . . While public interest may demand increased attention to safety and soundness in financial institutions, there is no economic framework suggesting that owners of [diversified] investment funds should care about safety, soundness, and default-related costs. Why should they be concerned with downside risk? Furthermore, much of the monitoring by equity holders that is predicted in the governance literature cannot be directed to the risk of failure. If it does exist in any form, it must instead be directed to value enhancement. After all, from the perspective of institutional investors, their own job is value maximization for their own shareholders."). *See also* Ing-Haw Cheng, Harrison Hong & Jose A. Scheinkman, Yesterday's Heroes: Compensation and Creative Risk-Taking, NBER Working Paper No. 16176 at 5 (2010) ("there is plentiful evidence that institutional investors care greatly about companies making quarterly earnings targets, presumably because the accompanying growth in share prices helps the institutional investors' portfolio performance"). *See also* Mehran, Morrison & Shapiro, *supra* note 12, at 13 (citing findings of "a significant positive relationship between institutional ownership and multiple measures of riskiness").

[56] Armour & Gordon, *supra* note 5, at 38. In their view, relaxing the traditional share value maximization norm for large financial firms would not increase agency costs because "the firm's majoritarian diversified shareholders would prefer that the managers did not impose systemic externalities." *Id.* at 39.

[57] *Id.* at 64.

[58] *Id.* at 55.

[59] *Id.* at 58–59. The belief that certain executive compensation arrangements induced excessive risk-taking by management in the run-up to the financial crisis produced many calls for legislative and regulatory action to curb incentive compensation practices, particularly those based on short-term share price appreciation. *See, e.g.,* Kenneth R. French et al., The Squam

they propose to extend the special committee approach used to deal with other corporate conflicts to the "imbedded" conflicts that they assert a highly incentivized management team face. A special committee process is typically used on an *ad hoc* basis to consider a proposed transaction involving a potential conflict between the company's interests and the interests of directors, a

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LAKE REPORT: FIXING THE FINANCIAL SYSTEM *75–85* (2010); Roberta Romano & Sanjai Bhagat, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359 (2009); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010). The Dodd-Frank Act includes several provisions addressing executive compensation, including a so-called "say on pay" provision, a provision requiring an independent compensation committee for publicly listed companies, and a provision requiring the federal bank regulators and other federal agencies to issue regulations prohibiting incentive-based compensation arrangements that encourage inappropriate risk-taking by covered financial institutions. *See* Dodd-Frank Act, § 951 (codified at 15 U.S.C. § 78n-1) (say on pay), § 952 (codified at 15 U.S.C. § 78j-3) (independent compensation committee) & § 956 (codified at 12 U.S.C. § 5641) (requiring regulations prohibiting inappropriate incentive-based compensation arrangements). The federal agencies issued proposed regulations implementing § 956 in April 2011 and reissued proposed regulations in 2016. *See* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37670 (June 10, 2016).

The regulation of compensation practices is a topic of enduring controversy. A recent research paper suggests that differences in manager "style" far outweigh executive compensation practices in explaining risk and performance across banks. *See* Jens Hagendorff, Anthony Saunders, Sascha Steffen & Francesco Vallascas, The Wolves of Wall Street: Managerial Attributes and Bank Business Models (April 20, 2016), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2670525. As a further matter, some commentators have suggested that providing a greater shareholder voice in corporate governance may actually result in greater risk-taking, particularly at large financial firms. *See, e.g.*, Brian R. Cheffins, *The Corporate Governance Movement, Banks, and the Financial Crisis*, 16 THEORETICAL INQUIRIES IN LAW 1, 41 (2015) ("To the extent that the Dodd-Frank Act reforms empower shareholders of banks, this enhances their ability to pressure bank executives to pursue high-risk strategies that regulators seem to oppose, particularly because banks' primary creditors—the depositors—have little incentive to impose a check on shareholder-backed risk-taking due to deposit insurance that the Federal Deposit Insurance Corporation provides.") (footnotes omitted); John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 813–814 (2011) ("Public policy must seek to counteract the excessive shareholder tolerance for risk in the case of major financial institutions. A focus that is limited to regulating managerial compensation is myopic because even if compensation had been strictly regulated by the Dodd-Frank Act (and it was not), shareholders of financial institutions could find other means by which to pressure and incentivize their management. Ironically, the Dodd-Frank Act has actually increased the ability of shareholders to pressure managers to increase leverage and accept greater risk."); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 653–654 (2010) ("In the years preceding the financial crisis, shareholders validated the strategies of the very financial firms that pursued high-leverage, high-return, and high-risk strategies and penalized those that did not. It is hard to see how shareholders, having played a role in fomenting the crisis, have a positive role to play in its resolution.").

controlling shareholder, or the management. It is not clear that the special committee analogy is apt here because the conflicts that the observers assert a highly incentivized management face will routinely arise in making basic decisions about the business operations of the company. Moreover, in proposing the idea of a "special committee" approach akin to the approach used to address conflicts arising from the interests of individual directors or management, the observers do not address whether the members of the risk committee would be entitled to the benefits of a provision like section 141(e) of the Delaware General Corporation Law, which protects directors in relying in good faith on information, opinions, reports or statements received from officers of the corporation.[60]

Second, the observers propose that there should be an oversight framework in which the board actively oversees the level of risk-taking, including risk-taking in operations and strategy, not just compliance with legal norms. This element is presumably based on the observers' concern that the monitoring duty of directors under Delaware case law may not extend to business operations as opposed to compliance with laws and regulations.[61] Best practices and supervisory requirements have already led major financial firms to exercise

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[60] As the observers note, traditional economic theory holds that incentive compensation should be used to align management preferences (which *ceteris paribus* would be more risk averse) with shareholder preferences for share value maximization (which would be more risk tolerant). Armour & Gordon, *supra* note 5, at 36. *See also* Mehran & Mollineaux, *supra* note 55, at 8 ("The principal-agent problem is elegantly solved by making management explicitly responsible for the value maximization of the firm."). The observers, however, posit that contrary to the traditional theory, high-powered incentive compensation arrangements exacerbate the conflict between managers (who will now prefer more risk) and diversified shareholders of systemically important firms (who should prefer less risk.) Armour & Gordon, *supra* note 5, at 55. Under the observers' proposal, the directors of the risk committee will be presented with management's analyses and projections of various risk matters, including the probability of a loss, the range of possible loss, and the range of risk-adjusted returns. The directors will unlikely be in a position to develop their own independent analyses or estimates of these risk metrics. Instead, they would in the normal course rely on the analysis and projections prepared by management. *See* EDWARD P. WELCH ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW: FUNDAMENTALS § 141.12 (2016 ed.) ("When directors rely on [opinions, reports, or statements by the officers of the corporation], they necessarily do so on the presumption that the information provided is both accurate and complete."). Under the presumption articulated by these observers, however, the management's analysis of risk is likely to be biased by high-power compensation incentives, potentially casting doubt on the objectivity and impartiality of the risk analysis being presented to the committee. The observers do not address the question whether their proposal would in effect deny the members of the risk committee the protection of good faith reliance on such information under a provision like section 141(e) of the Delaware General Corporation Law because of the presumed bias of the management.

[61] Armour & Gordon, *supra* note 5, at 67 (citing the decision in *In re Citigroup Inc. S'holder*

rigorous oversight over business operations as well as over compliance issues. Accordingly, this element of the proposal would simply confirm what the boards of major financial firms are already doing.

Third, the observers propose that there should be a director standard of care that is negligence-based "because the risk-neutral heuristic associated with the business judgment rule is inappropriate where systemic risks are concerned."[62] The effect of this requirement would be to impose a simple negligence standard for monitoring as opposed to a bad faith standard and to remove the protection of the business judgment rule for corporate decision-making. In this respect the proposal would up-end well-established corporate practice and case law.

However intriguing the observers' theory as to the risk preference of diversified shareholders, the observers' proposal itself is marked by a high degree of indeterminancy. First, the set of institutions subject to the heightened director oversight standard is indeterminate. The observers suggest that the set of institutions could be defined by reference to a regulatory designation, such as a designation by the Financial Stability Oversight Council or the Financial Stability Board. But alternatively, they suggest that the set of the firms to which the heightened duty would apply could be left to an *ex post* judicial determination.[63] Here as elsewhere in their proposal, the observers appear to be disinclined to predictability or clarity. This appears to be a calculated indeterminancy.

Second, the observers suggest that to achieve the appropriate deterrent effect, "the expected damages payable should in principle equal the expected social cost of activities imposing externalities."[64] But the observers also recognize that "systemic losses" cannot readily be calculated and would likely be so large that they would render an individual or a firm bankrupt and judgment-proof. In the face of these substantial problems, the observers suggest that capping liability for any "significant" loss by reference to the directors' earnings has "desirable" properties, such as "avoiding strong disincentives to director service by the most qualified."[65] In fact, the proposal even with a cap would create a very strong

Deriv. Litig., 964 A. 2d 106 (Del. Ch. 2009)). The *Citigroup* decision and its implications are discussed in Part I of this article.

[62] *Id.* at 64.

[63] *Id.* at 70.

[64] *Id.* at 70.

[65] *Id.* at 69. In this regard, the observers note that the new resolution authority for systemically important financial firms in Title II of the Dodd-Frank Act would allow the FDIC as receiver to recoup two years of compensation from those senior executives or directors of a failed financial firm who are found to be substantially responsible for the failed condition of the

disincentive for service as a director of a systemically important financial institution (or an institution that might be determined in judicial hindsight to be systemically important).

Third, the proposal does not define what would constitute a "significant loss" other than by reference to a loss of "a magnitude and type that threaten the firm's stability."[66] But these observers also specifically envision that this liability could—indeed should—attach to a "significant" loss that does not cause the failure of the institution or result in a systemic loss to the financial system. The observers argue that there should be a remedy for the incurrence of systemic risk before a systemically important financial firm actually fails and imposes systemic losses on the financial system. They argue that for a firm to face liability for causing systemic externalities only when it has failed would undermine the liability's deterrent effect.[67] Thus, the proposal is specifically designed not to rely on a failure of the firm or a systemic loss having occurred. Although articulated as a systemic harm measure, the proposal would appear to apply to a loss incurred by a systemically important financial institution that does not itself result in systemic harm or threaten the solvency of the institution, but which a court determines *ex post* might ***hypothetically, if incurred in a greater amount or under other circumstances,*** have caused systemic harm or have threatened the institution's financial stability.

The only specific example the observers cite for possible use of the new standard is the $6 billion "London Whale" loss at JP Morgan Chase.[68] The $6 billion loss suffered by JPMorgan Chase principally in the second quarter of 2012 did not result in any systemic harm nor did it materially affect the capital level or financial stability of JPMorgan Chase. JPMorgan Chase reported earnings of $21.3 billion for 2012, a 12 percent increase over its 2011 earnings even after incurring the losses related to the London Whale trading activities.[69]

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company. *Id.* at 72. *See* Dodd-Frank Act, § 210(s) (codified at 12 U.S.C. § 5390(s)). The FDIC has by regulation established an ordinary negligence standard for determining whether a senior executive or director is substantially responsible for the failed condition. 12 C.F.R. § 308.7(a) (2016). The FDIC has also established certain presumptions that would apply in determining whether a senior executive officer or director was substantially responsible for the failed condition. For example, the person serving as the chairman of the board will be presumed to have been substantially responsible for the failed condition unless that person joined the board during the two-year period prior to its failure under an agreement to assist in preventing further deterioration of the financial condition of the company. 12 C.F.R. § 308.7(b)(1) & (3) (2016).

[66] *Id.* at 73.

[67] *Id.* at 37.

[68] *Id.* at 73.

[69] JPMorgan Chase & Co., 2012 Annual Report on Form 10-Q for 2012, at 69 & 188.

JPMorgan Chase reported total shareholders' equity of $204 billion as of December 21, 2012, an 11 percent increase over its total shareholders' equity as of December 31, 2011.[70] In no sense can the London Whale loss be regarded as one that threatened the earnings capacity, the capital position or (far less) the solvency of JPMorgan Chase.[71] The most that can be said is that the London Whale loss was "significant" from an earnings perspective for the quarter in which it was principally incurred.

Fourth, the observers expressly envision that the test for director liability would be applied independent of the regulatory norms to which the firm might otherwise be subject. The observers assert that their proposal "reserves to the courts power to assess *ex post* whether or not risk-oversight systems were adequate, regardless of the level of regulatory compliance."[72] In this respect the proposal appears to apply the same level of skepticism to the judgment of regulators in designing regulatory requirements as it does to the judgment of senior management (which the observers expressly characterize as skewed by high-powered incentive compensation) in designing risk management systems.[73] It is inconsistent with prevailing notions of good faith behavior under corporate law to suggest that directors are not entitled to place significant weight on regulatory requirements or guidance in reviewing and overseeing risk management systems in the absence of actual knowledge that the regulatory requirements or guidance are inappropriate or inadequate for a specific institution.

Fifth, the observers indicate that while industry standards would be a starting point for judicial analysis, compliance with industry standards would not guarantee that the directors have met the required oversight standard because industry-wide standards themselves (which presumably meet or *exceed* regulatory *minima*) may be deemed to be deficient as determined in hindsight by a court. This is yet another example of calculated indeterminancy in the proposal. Indeed, the proposal reflects more than just indeterminancy. It reflects a rejection of much of the public policy that underlies board governance. In

[70] *Id.* at 190.

[71] *See* Office of the Inspector General, Board of Governors of the Federal Reserve System, Evaluation Report 2014-SR-B-017, *The Board Should Enhance Its Supervisory Process as a Result of Lessons Learned From the Federal Reserve's Supervision of JPMorgan Chase & Company's Chief Investment Office* 9 (2014) ("The [Chief Investment Office] losses reduced JPMorgan Chase's earnings but did not jeopardize the institution's solvency or diminish its capital position.") (footnote omitted).

[72] *Id.* at 68.

[73] *Id.* at 55–56.

positing that a court should be free to find *ex post* that industry standards were deficient, the observers say that "[i]n this regard, judicial hindsight bias becomes a virtue, rather than a vice, of such liability."[74]

At every turn the observers appear to have opted for indeterminancy. The indeterminancy of the liability test is presumably intended to deter directors at the margin from permitting greater risk-taking by the management. But the indeterminancy of the liability test will more likely deter individuals at the outset from even considering service as directors. This proposal may have (to borrow a term used by the observers) a "heuristic" character of its own because it is likely to apply only to a null set. It is unlikely that any qualified individual would be prepared to serve as an independent director of a systemically important financial firm on the terms of this proposal.

The theory of these observers as to the risk preference of diversified shareholders nonetheless provides a useful perspective for the analysis of the numerous post-crisis regulatory and supervisory initiatives aimed at addressing systemic risk in the financial system. Federal Reserve Board Governor Daniel K. Tarullo has described the analysis offered by these observers as to the preference of diversified shareholders for less risk-taking by systemically important firms as suggesting that the "customary tension between regulatory and diversified shareholders' interests may be considerably mitigated in the case of systemically important firms."[75] If so, diversified shareholders should actually embrace the efforts of the federal bank regulators to mitigate the systemic risk presented by the largest banking institutions through heightened regulatory and supervisory measures. Concern for systemic risk has dominated the thinking of the bank regulators since the time of the financial crisis. The regulatory and supervisory measures aimed at mitigating the systemic risk presented by the largest financial institutions and the effect of these measures on governance are the subject of the next section of this article.

THE DODD-FRANK ACT REGIME

The sudden collapse of several major financial institutions and the parlous state of other major institutions at the time of the financial crisis led legislators and regulators to reassess the prevailing regulatory and supervisory model. The legislators' response to the problems identified in financial regulation and supervision was the Dodd-Frank Act. The titles of the Dodd-Frank Act

[74] *Id.* at 69 n.53 (citation omitted).

[75] Daniel K. Tarullo, Corporate Governance and Prudential Regulation, Speech at the Association of American Law Schools 2014 Midyear Meeting (June 9, 2014).

catalogue the many areas of identified concern, such as over-the-counter derivatives, executive compensation, and securitization activities. Pride of place in the Dodd-Frank Act, however, was accorded to the provisions of Title I, which were designed to strengthen the regulation and supervision of large banking institutions and other systemically important nonbank financial companies. Section 165 is at the core of the provisions in Title I. Section 165(b) directs the Federal Reserve Board to establish enhanced prudential standards for bank holding companies with $50 billion or more of consolidated assets and for other nonbank financial companies designated as systemically important by the Financial Stability Oversight Council ("designated nonbank financial companies"). The enhanced standards are required to be more stringent than those applicable to bank holding companies and nonbank financial companies that do not present similar risks to financial stability. The enhanced prudential standards include risk-based capital requirements, leverage limits, liquidity requirements, overall risk management requirements, resolution plan and credit exposure requirements and concentration limits.[76] The Federal Reserve Board has engaged in extensive rulemaking processes to implement the enhanced prudential requirements established by the Dodd-Frank Act. The enhanced prudential requirements directly implicate the governance role of the board of directors.

Resolution Planning

In one of their first actions implementing Dodd-Frank Act requirements, the Federal Reserve Board and the FDIC in April 2011 proposed and in November 2011 adopted a regulation implementing the resolution plan requirement contained in section 165(d) of the Dodd-Frank Act. [77] Section 165(d) requires each bank holding company with $50 billion or more in consolidated assets and each designated nonbank financial company to submit to the Federal Reserve Board and the FDIC a plan for the rapid and orderly resolution of the company in the event of material financial distress or failure. This is one of the most comprehensive planning processes required by the Dodd-Frank Act.

Section 165(d) does not by its terms require that a resolution plan submitted

[76] Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376, 1424 (2010), § 165(b)(1)(A). Under § 165(b)(1)(B), the Federal Reserve Board may establish additional prudential standards, including a contingent capital requirement, enhanced public disclosures, short-term debt limits, and any other prudential standards that the Federal Reserve Board deems appropriate.

[77] Resolution Plan and Credit Exposure reports required, 76 Fed. Reg. 22,648 (proposed Apr. 22, 2011). *See* 76 Fed. Reg. 67,323 (Nov. 1, 2011) for release of final rule (codified at 12 C.F.R. Pt. 243).

to the Federal Reserve Board and the FDIC be approved by the board of directors of the submitting company, but because of the obvious strategic issues involved in the preparation and consideration of such a plan, the Federal Reserve Board and the FDIC provided in their rule that a resolution plan must be approved by the board of directors of the company.[78] The rule requires that the resolution plan contain a detailed description of the corporate governance relating to resolution planning, including the extent and frequency of reporting to the senior management and board of directors regarding the resolution planning process.[79]

Unlike other provisions in the Dodd-Frank Act, which are intended to "enhance" existing regulatory or supervisory requirements in such areas as capital or liquidity, the resolution plan requirement is part of a new regulatory regime specifically designed to address macroprudential concerns, including systemic risk. As such, the resolution planning process represents an entirely new challenge confronting senior management and the board of directors. The resolution plans submitted to the Federal Reserve Board and the FDIC are complex and typically thousands of pages in length, requiring close scrutiny by senior management and the board. Responding to the criticisms that the Federal Reserve Board and the FDIC have made to the resolution plans as filed has also required strategic analysis by management and the board and in many cases significant changes in corporate structure and operations.

Capital Planning

As another one of its early steps in strengthening the oversight of large banking institutions, the Federal Reserve Board in June 2011 proposed and in December 2011 adopted an amendment to Regulation Y to require bank holding companies with $50 billion or more in consolidated assets to submit an annual capital plan to the Federal Reserve Board and to obtain prior approval for capital distributions.[80] While this regulation was not required by the Dodd-Frank Act, the Federal Reserve Board concluded that it was appropriate to hold large bank holding companies to an elevated capital planning standard because of the elevated risk to the financial system posed by large bank holding companies.[81] In that regard, the Federal Reserve Board noted that during the years leading up to the financial crisis, many bank holding companies had made

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[78] 12 C.F.R. § 243.3(e) (2016). *See* 76 Fed. Reg. at 67,331.

[79] 12 C.F.R. § 243.4(d)(1)(iv) (2016).

[80] Capital Plans, 76 Fed. Reg. 76,631 (Dec. 1, 2011) (codified at 12 C.F.R. § 225.8).

[81] Capital Plans, 76 Fed. Reg. 35,351, 35,352 (proposed Jun. 17, 2011).

significant distributions of capital in the form of stock repurchases and dividends without adequate consideration of the effects that a prolonged economic downturn could have on their capital adequacy.[82] The Federal Reserve Board also noted that the proposal for a capital plan requirement was consistent with its new supervisory practice, the Supervisory Capital Assessment Program ("SCAP"), first implemented in early 2009.[83] Under SCAP, the Federal Reserve Board conducted a stress test of 19 large domestic bank holding companies to determine whether they had enough capital to withstand a more-adverse-than-anticipated economic environment.[84] The SCAP exercise was regarded as a key factor in restoring confidence in the U.S. banking system in 2009. In 2011 the Federal Reserve Board instituted an annual exercise, the Comprehensive Capital Analysis and Review ("CCAR"), as a standing process to assess the capital adequacy of large bank holding companies.[85] CCAR involved a forward-looking evaluation (over a 24-month period planning horizon) of the internal capital planning processes at 19 large bank holding companies against stressful economic and financial conditions.[86] The capital planning provision incorporated into Regulation Y was essentially a codification of this new supervisory practice.

The capital planning rule provides that for bank holding companies with consolidated assets of $50 billion or more, the board of directors, or a designated committee of the board, must at least annually

(a) review the robustness of the bank holding company's process for assessing capital adequacy;

(b) ensure that any deficiencies in the bank holding company's process for assessing capital adequacy are appropriately remedied; and

(c) approve the bank holding company's capital plan for submission to the Federal Reserve Board.[87]

The Federal Reserve Board has emphasized the extent of board oversight that it

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[82] 76 Fed. Reg. at 35,351.

[83] *Id.* at 35,352.

[84] *Id.*

[85] *Id.*

[86] *Id. See also* Board of Governors of the Federal Reserve System, *Comprehensive Capital Analysis and Review: Objectives and Overview* (March 18, 2011). For a detailed discussion of the current CCAR and stress testing processes, see Federal Reserve Board Governor Daniel K. Tarullo, Stress Testing after Five Years, Remarks at the Federal Reserve Third Annual Stress Test Modeling Symposium (June 25, 2014).

[87] 12 C.F.R. § 225.8(d)(l)(iii) (2016).

expects to see in the capital planning process. In adopting the rule, the Federal Reserve Board explained its view of the role of the board as follows:

> As part of their fiduciary responsibilities to a bank holding company, the board of directors and senior management bear the primary responsibility for developing, implementing, and monitoring a bank holding company's capital planning strategies and internal capital adequacy processes. The final rule does not diminish that responsibility. Rather, the final rule is designed to (i) establish common minimum supervisory standards for such strategies and processes for certain large bank holding companies; (ii) describe how boards of directors and senior management of these bank holding companies should communicate the strategies and processes, including any material changes thereto, to the Federal Reserve; and (iii) provide the Federal Reserve with an opportunity to review bank holding companies' capital distributions under certain circumstances.[88]

The capital planning rule requires a robust set of projections over a nine quarter planning horizon, testing projected capital levels against stress scenarios developed by the bank holding company as well as stress scenarios supplied by the Federal Reserve Board. The Federal Reserve Board has indicated that it expects effective board and senior management oversight of the capital planning process, including, for example, periodic review of capital goals, assessment of the appropriateness of the adverse scenarios used in capital planning, and regular review of any limitations and uncertainties in the process.[89] In the capital plan rule the Federal Reserve Board has reserved the authority to object to a capital plan on either quantitative or qualitative grounds. If the Federal Reserve Board objects to a capital plan, the bank holding company may not make a capital distribution unless the Federal Reserve Board indicates that it does not object to the distribution. The capital planning and CCAR processes have assumed critical importance for shareholders because share buy-back programs and increases in quarterly dividends are directly dependent upon satisfactory results from the planning process and the CCAR analysis.

In 2013 the Federal Reserve Board provided guidance on its expectations for the capital planning process, including the expectations relating to the role of directors in the governance process for capital planning.[90] The guidance

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[88] 76 Fed. Reg. at 74,632.

[89] 76 Fed. Reg. at 74,634.

[90] Board of Governors of the Federal Reserve System, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (Aug. 2013).

document observed that in the case of some bank holding companies, the board of directors did not receive information about governance and control over the internal capital planning process, making it difficult to assess the strength of the capital planning process and whether the results were reliable and credible.[91] The guidance document also observed that bank holding companies with weaker documentation processes had board minutes that were very brief and opaque with little reference to the information used by the board to make its decisions.[92] It also noted that some companies did not formally document key decisions by the board or provide evidence that the board challenged the management on their recommendations.[93]

In 2015 the Federal Reserve Board provided further guidance on its expectations surrounding the capital planning process, including in particular the governance process for capital planning.[94] The guidance includes a section directed to the governance role of the board in the capital planning process. The guidance indicates that the management should provide the board with reports on the capital planning process at least quarterly or whenever economic or firm-specific conditions warrant. [95] The reports should cover such matters as estimation approaches, model overlays and assessments of model performance, sensitivity analysis of the company's projections to changes in assumptions and any problems identified by management or the bank supervisors.[96] According to the guidance, the firm's internal audit function should report to the board (or a committee of the board) on a quarterly basis as to the status of its key findings

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[91] *Id.* at 12. Of the 18 companies submitting capital plans in 2013, two were required to submit new capital plans to address weaknesses in their capital planning process, one received an objection based on quantitative and qualitative grounds and one received an objection based on qualitative grounds.

[92] *Id.*

[93] *Id.*

[94] Board of Governors of the Federal Reserve System, SR 15–18, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms* (Dec. 18, 2015) & SR 15–19, *Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms* (Dec. 18, 2015). The Federal Reserve Board has set higher expectations for the capital planning process under SR 15–18 for LISCC firms and large and complex firms than for large and noncomplex firms under SR 15–19.

[95] *Id.* Attachment SR 15–18 at 4 & Attachment SR 15–19 at 4.

[96] *Id.* Attachment SR 15–18 at 5 & Attachment SR 15–19 at 5. Attachment SR 15–18 also provides that material overlays to the capital model should receive a heightened level of scrutiny up to and including review by the board or a designated committee in instances where the impact on pro forma results is material. Attachment SR 15–18 at 24.

relating to the capital planning process.[97] The board should approve policies related to capital planning and review them annually, and approve capital planning activities and strategies. The guidance directs boards to maintain an accurate record of its meetings pertaining to the firm's capital planning process.[98]

The capital plans of large complex firms are often thousands of pages long, and involve a year-long process that demands regular board attention. While some boards delegate to a committee responsibility for receiving and reviewing technical updates on a quarterly, or even monthly, basis, the entire board of directors is expected to review the full capital plan and understand its major features, prior to their approval of it.

The capital plan requirement and related CCAR process presented significant challenges to companies in the initial periods of implementation. It appears based on the results of the 2015 and 2016 CCAR analyses that the largest U.S. bank holding companies and most large foreign banking organizations operating in the United States have made significant progress in building out their capital planning processes as well as increasing their absolute capital levels. In 2015 and 2016, the Federal Reserve Board did not object to the capital plans submitted by any banking institutions based on quantitative grounds, but it objected to the capital plans submitted by two foreign banking organizations on qualitative grounds.[99] The objections based on qualitative grounds emphasize the continuing importance of strong governance over the capital planning process.

In addition to the capital plan rule, the Federal Reserve Board as well as the OCC and FDIC have adopted new quantitative capital rules for U.S. banks and bank holding companies, based upon but in important respects more stringent than the capital standards set by the Basel Committee. As a governance matter, the quantitative capital rules require board oversight and specific board approval of such matters as a formal public disclosure policy relating to the bank's capital ratios and calculations and for banks that are required to calculate their capital requirements under the advanced approaches capital rule, additional review and approval of the advanced systems and processes that those banks must have in

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[97] *Id.* Attachment SR 15–18 at 31 & Attachment SR 15–19 at 25–26.

[98] *Id.* Attachment SR 15–18 at 5 & Attachment SR 15–19 at 5.

[99] Board of Governors of the Federal Reserve System, *Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results* 2–3 (2016). The same two foreign banking organizations received objections on qualitative grounds in 2015 and 2016.

place to model and calculate their capital requirements.[100]

Stress Testing

Section 165(i) the Dodd-Frank Act codified into law the new supervisory practice of stress testing as initially reflected in SCAP and subsequently in CCAR. Section 165(i)(1) requires the Federal Reserve Board to conduct annual stress tests on bank holding companies with consolidated assets of $50 billion or more and on designated nonbank financial companies. Section 165(i)(l) specifies that these "regulator-run" stress tests must provide for at least three different scenarios or sets of conditions, including a baseline, adverse and severely adverse. Section 165(i)(2) requires these companies and certain other regulated financial companies with more than $10 billion in consolidated assets to conduct their own "company-run" stress tests. A summary of the results of both the regulator-run stress tests and the company-run tests are publicly disclosed. The regulator-run stress tests and the company-run stress tests provide the basis for the analysis of the capital plans submitted by the large bank holding companies under the capital plan rule discussed above.

The Federal Reserve Board has included in Regulation YY, its enhanced prudential standards regulation, rules for a Federal Reserve Board-run stress test for bank holding companies with consolidated assets of $50 billion or more and designated nonbank financial companies.[101] Regulation YY also includes rules for semi-annual company-run stress tests applicable to bank holding companies with consolidated assets of $50 billion or more and designated nonbank financial companies and annual company-run stress tests for bank holding companies and certain other financial companies with consolidated assets of more than $10 billion.[102] For company-run stress tests, Regulation YY requires the board of directors, or a committee thereof, to review and approve the policies and procedures of the stress testing processes as frequently as economic conditions or the conditions of the company may warrant, but no less than annually.[103] The board must consider the results of the stress test when taking

[100] *See* 12 C.F.R. § 217.62(b) (standardized approach disclosures); 12 C.F.R. § 217.172(c)(2) (advanced approaches disclosures); 12 C.F.R. § 217.122(i)(2) (requiring annual board review and approval of advanced systems); & 12 C.F.R. § 217.212(b) (market risk capital disclosures).

[101] 12 C.F.R. §§ 252.41–252.47 (2016).

[102] 12 C.F.R. §§ 252.11–252.17 & §§ 252.51–252.58 (2016).

[103] 12 C.F.R. §§ 252.15(c)(2) & 252.56(c)(2) (2016).

capital actions, assessing exposures or risk positions, and implementing recovery or resolution plans.[104]

Liquidity Planning

Section 165(b)(i)(A)(ii) of the Dodd-Frank Act provides that the Federal Reserve Board shall establish enhanced liquidity requirements for bank holding companies with consolidated assets of $50 billion or more and designated nonbank financial companies. Prior to the Dodd-Frank Act, the bank regulatory agencies used supervisory guidance rather than rules to address liquidity matters in banking institutions. The financial crisis highlighted the importance of more robust liquidity risk management measures than had been required in the past.[105] The Federal Reserve Board has addressed liquidity requirements in two regulations. The Federal Reserve Board has implemented in Regulation WW a quantitative liquidity requirement in the form of a liquidity coverage ratio and has proposed a net stable funding ratio generally based on the liquidity standards set by the Basel Committee on Banking Supervision.[106]

The Federal Reserve Board has also implemented qualitative liquidity risk management requirements in Regulation YY.[107] As originally proposed, the qualitative liquidity risk management provisions in Regulation YY would have imposed very significant responsibilities on the board and risk committee of large bank holding companies. (The Dodd-Frank Act requirements for risk committees are discussed below.) In response to industry comments that the proposed rule inappropriately imposed operational responsibilities on the board and risk committee, the Federal Reserve Board made a number of significant changes to the qualitative liquidity risk management provisions in the final rule to reflect a more appropriate scope of oversight for the board and the risk committee.[108] For example, the proposed rule would have required the risk committee to approve the liquidity costs, benefits and risks of each significant new business line and significant new product.[109] The final rule significantly

[104] 12 C.F.R. §§ 252.15(c)(3) & 252.56(c)(3) (2016).

[105] *See, e.g.*, Senior Supervisors Group, *Risk Management Lessons from the Global Banking Crisis of 2008* 13 (2009).

[106] 12 C.F.R. Part 249 (2016); Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements, 81 Fed. Reg. 35,124 (proposed June 1, 2016).

[107] 12 C.F.R. §§ 252.34–252.35 (2016).

[108] *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,252–17,257 (Mar. 27, 2014).

[109] *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 606 (proposed Jan. 5, 2012).

cut back on the scope of responsibility originally proposed for the board and the risk committee, placing responsibility instead in the hands of senior management.[110] The final rule requires the board to approve the liquidity risk tolerance of the firm at least annually and to review at least semi-annually whether the company is operating within the risk tolerance.[111] The board is also required to review and approve the liquidity risk management strategies, policies and procedures established by senior management and the risk committee is required to approve a contingency funding plan annually and any material revisions to the plan.[112] The final rule places responsibility on senior management for an extensive and detailed set of liquidity risk management requirements, including quarterly reporting on the liquidity risk profile and liquidity risk tolerance to the board. [113]

The robust and detailed requirements in the liquidity risk management provisions of Regulation YY attest to the high priority that the bank regulators attach to liquidity concerns in the post-crisis world and the need to ensure resilience in funding in the face of future adverse market events. The bank regulators intend to hold the largest banking institutions to the highest liquidity standards as well as highest capital standards. The Federal Reserve Board has implemented a Comprehensive Liquidity Analysis and Review ("CLAR"), akin to CCAR, to evaluate forward-looking liquidity stress testing and risk management practices at the very largest banking institutions.[114] Rigorous oversight of management's processes for liquidity risk management must thus be a high priority for the board of every large banking institution.

Risk Committee

Title I of the Dodd-Frank Act contains one provision that specifically addresses board structure and governance. Section 165(h)(1) provides that the Federal Reserve Board shall require each designated nonbank financial company that is publicly traded to establish a risk committee of the board. Section

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[110] *See* 12 C.F.R. § 252.34(c). *See also* 79 Fed. Reg. at 17,254 (providing, for example, that senior management rather than the risk committee is to review and approve new products and business lines and evaluate liquidity costs, benefits and risks related to each new business line and product that could have a significant effect on the company's liquidity risk profile).

[111] 12 C.F.R. § 252.34(a)(1) (2016).

[112] 12 C.F.R. § 252.34(a)(2) & § 252.34(b) (2016).

[113] 12 C.F.R. § 252.34(c) (2016).

[114] For a detailed analysis of the new regulatory approaches to liquidity, including the CLAR process, see Federal Reserve Board Governor Daniel K. Tarullo, Liquidity Regulation, Speech at the Clearing House 2014 Annual Conference (Nov. 20, 2014).

165(h)(2))(A) similarly provides that the Federal Reserve Board shall require each bank holding company that is publicly traded and that has $10 billion or more in consolidated assets to establish a risk committee of the board. The risk committee is to be responsible for oversight of the enterprise-wide risk management practices of the company, with such number of independent directors as the Federal Reserve Board determines is appropriate and with at least one risk management expert with experience in risk exposures of large complex firms.

The Federal Reserve Board has implemented the provisions of section 165(h) in Regulation YY.[115] Regulation YY provides that a publicly traded bank holding company with $10 billion or more in consolidated assets must maintain a risk committee, with an independent director as chair and with at least one member that has risk management experience with large complex firms. The risk committee must meet at least quarterly. Regulation YY also requires every bank holding company with consolidated assets of $50 billion or more to establish a risk committee. [116] For these larger bank holding companies, the risk committee must be an independent standalone committee that has the sole and "exclusive" responsibility for risk management policies and oversight of the company's global risk management framework.[117] An audit committee with general risk management responsibility does not qualify as a risk committee for purposes of this provision in Regulation YY.[118] In adopting the rule, the Federal Reserve Board noted that a standalone risk committee was consistent with industry practice, with large complex banking organizations commonly using a risk committee that is distinct from other committees of the board.[119] The risk committee must be chaired by an independent director and must have at least one member with risk management experience with the exposures of large complex financial firms. Regulation YY also requires a bank holding company with consolidated assets of $50 billion or more to have a chief risk officer with experience with risk exposures of large complex financial firms. The chief risk officer must report directly both to the risk committee of the board and the chief executive officer of the company. These requirements in

[115] 12 C.F.R. §§ 252.21–252.22 & 252.33 (2016).

[116] 12 C.F.R. § 252.33 (2016).

[117] 12 C.F.R. § 252.33(a)(3)(ii) (2016).

[118] For bank holding companies with consolidated assets of less than $50 billion, however, the risk committee functions may be performed by another committee of the board such as an audit or finance committee. *See* 79 Fed. Reg. 17,240, 17,250 (March 27, 2014).

[119] *Id.*

Regulation YY reflect what many large financial firms had already adopted as best practices.

Criticism of the Dodd-Frank Act Approach to Governance

The extensive rulemakings undertaken to implement section 165 of the Dodd-Frank Act have added a new macroprudential dimension to the previous regulatory and supervisory regime for bank holding companies (and now designated nonbank financial companies). There is only one provision in section 165 that expressly addresses board governance issues, the section 165(h) risk committee provision. Some observers have criticized the Dodd-Frank Act for its failure to do more to strengthen the governance responsibilities of directors.[120] Although only subsection (h) of section 165 expressly addresses governance, the legislative prominence accorded the macroprudential rules under section 165 necessarily implicates the governance role of the board. Thus, it comes as no surprise that in fashioning the rules implementing section 165 the Federal Reserve Board expressly incorporated governance requirements, including a specific board governance role. In response to the perception of weak board oversight as a contributing factor to the financial crisis, the Federal Reserve Board has in its rulemakings under section 165 as well as in its rulemakings under other sections of the Dodd-Frank Act reenforced its longstanding focus on the role of the board in corporate governance.[121] Besides

[120] *See, e.g.*, Cheffins, *supra* note 59, at 40–41 ("corporate governance reform was not a feature of the key bank-specific provisions in the Dodd-Frank Act"); Macey & O'Hara, *supra* note 26, at 1–2 ["[T]he inertia [against imposing additional responsibilities] with respect to bank directors is all the more puzzling given that Dodd-Frank explicitly addressed the externalities imposed by individual banks on the financial system yet imposed no additional requirements on bank directors to make them responsible for limiting such risks.") (footnote omitted). *See* generally Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. MICH. J. L. REFORM 55 (2011). Other observers have concluded that even the limited corporate governance provisions in the Dodd-Frank Act were unnecessary and ill-conceived. For a broad-ranging critique of the corporate governance provisions in the Dodd-Frank Act, see Stephen M. Bainbridge, Dodd-Frank: *Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

[121] In adopting regulations implementing the so-called Volcker Rule requirement in § 619 of the Dodd-Frank Act, the federal regulatory agencies have specifically provided for the implementation of a compliance plan by banking institutions and for approval of the compliance plan by the board of directors of large banking institutions. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5803 (Jan. 31, 2014) (codified at 12 C.F.R. Part 248 App. B). Likewise, the recently proposed regulations governing incentive compensation under § 956 of the Dodd-Frank Act would impose oversight and approval requirements on the board, and in

reenforcing the oversight role of the board in the new Dodd-Frank Act regulatory regime, the Federal Reserve Board and the OCC have taken steps to revisit their existing supervisory frameworks and to reemphasize the role of the board of directors in those supervisory frameworks.

THE HEIGHTENED STANDARDS REGIME

The Dodd-Frank Act involved a significant enhancement of regulatory requirements, particularly as applied to large bank holding companies and designated nonbank financial companies. In addition to the enhanced regulatory requirements imposed by the Dodd-Frank Act, the federal banking agencies have in direct response to the financial crisis adopted "enhanced" or "heightened" supervisory standards and frameworks for large banking institutions.

Federal Reserve Board Action

It may have been fortuitous, but in October 2008, shortly after the onset of the financial crisis, the Federal Reserve Board issued new guidance on its approach to the consolidated supervision of bank holding companies.[122] The Federal Reserve Board noted that while the initiation of work on the new guidance predated the recent period of "considerable strain" in the financial markets, the enhanced approach reflected in the new guidance included elements that would help to make the financial system more resilient, including through a heightened focus on capital and liquidity management.[123] Building on prior practice, the new guidance emphasized that one of the primary areas of focus for consolidated supervision of large complex bank holding companies would be the adequacy of governance provided by the board and senior management.[124] The new guidance articulated separate expectations for the role of senior management and the role of the board. Among the specific expectations that the guidance established for a board and its committees was "ensuring that [senior management] have the proper incentives to operate the organization in a safe and sound manner" and "[e]stablishing, communicating,

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the case of larger institutions an independent compensation committee of the board, for various elements in the compensation arrangements for covered financial institutions. *See* Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37670 (June 10, 2016).

[122] Board of Governors of the Federal Reserve System, SR 08-9/CA 08-12, *Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations* (Oct. 16, 2008).

[123] *Id.*

[124] *Id.* App. A.1 at 4.

and monitoring (for example, by reviewing comprehensive [management information systems] reports produced by senior management) institutional risk tolerance."[125] Establishing a risk appetite or risk tolerance for the firm has become an important responsibility for the board.

Building further on the lessons learned from the financial crisis and on the imperatives of the Dodd-Frank Act, the Federal Reserve Board in 2012 established a new framework for consolidated supervision of large financial institutions.[126] This new framework incorporates both traditional microprudential and new macroprudential elements to reduce the potential threats to the stability of the financial system. The framework has two objectives: The first objective is to enhance the resiliency of a large financial firm to lower the probability of its failure "by maintaining sufficient capital and liquidity and operational resilience through effective corporate governance, risk management and recovery planning."[127] The second objective is to reduce the impact on the financial system in the event of a large financial firm's failure through effective resolution planning.[128] The framework enumerates both broad and specific expectations for the role of the board in meeting these objectives. These expectations both build and, in light of the experience of the financial crisis, expand upon prior expectations for board governance.

The framework begins by setting forth a broad supervisory expectation for a board:

> The board is expected to establish and maintain the firm's culture, incentives, structure, and processes that promote its compliance with laws, regulations, and supervisory guidance.[129]

The framework then sets forth a number of specific expectations. One specific expectation is that the board with the support of senior management will maintain a clearly articulated strategy and institutional risk appetite.[130] Another expectation is that the board will "[e]nsure that management information systems (MIS) support the responsibilities of the board of directors to oversee the firm's core business lines, critical operations, and other core areas of

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[125] *Id.* App. A.1 at 4–5.

[126] Board of Governors of the Federal Reserve System, SR 12-17/CA 12-14, *Consolidated Supervision Framework for Large Financial Institutions* (Dec. 17, 2012) [hereinafter SR 12-17].

[127] *Id.* at 2.

[128] *Id.*

[129] *Id.* at 5. It should be noted that the framework document expressly calls for compliance with supervisory guidance as well as with laws and regulations.

[130] *Id.*

supervisory focus."[131] This expectation responds to the findings from the financial crisis that the management information systems of certain large financial institutions were incomplete or inadequate to advise the board on the full range of risk to which a firm was exposed.[132]

Another expectation is that the board will "[e]nsure the organization's internal audit, corporate compliance, and risk management and internal control functions are effective and independent, with demonstrated influence over business-line decision making that is not marginalized by a focus on short-term revenue generation over longer term sustainability."[133] This expectation responds to the dual perceptions that risk management and internal control functions at some firms had been marginalized in resources and influence prior to the crisis and that compensation and other business practices that emphasized short-term results over long-term results had promoted excessive risk-taking in the run-up to the crisis.[134] The responses necessary to address these and other perceptions from the financial crisis led the bank regulators to contemplate a "new era of bank supervision."[135]

The new era of bank supervision also called for changes in the internal organization of the supervisory function at the Federal Reserve Board. In 2010 the Federal Reserve Board established its Large Institution Supervision Coordinating Committee ("LISCC") to improve its oversight of the largest, most systemically important financial institutions.[136] The LISCC program covers eight U.S. banking organizations that have been identified as global systemically important banks by the Basel Committee, four foreign banking organizations with large complex U.S. operations, and four nonbank financial institutions designated as systemically important by Financial Stability Oversight Council.

[131] *Id.*

[132] *See, e.g.*, Senior Supervisors Group, *Risk Management Lessons from the Global Banking Crisis of 2008* (2009); Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (2008).

[133] SR 12–17, *supra* note 126, at 5.

[134] *See* sources cited *supra* note 132.

[135] *See* Sarah Dahlgren, Executive Vice President of the New York Federal Reserve Bank of New York, A New Era of Bank Supervision, Remarks at the New York Bankers Assn. Financial Services Forum (Nov. 11, 2011).

[136] *See* Board of Governors of the Federal Reserve System, SR 15-7, *Governance Structure of the Large Institution Supervision Coordinating Committee (LISCC) Supervisory Program* (April 17, 2015). *See also* Janet L. Yellen, Chairperson of the Board of Governors of the Federal Reserve System, Supervision and Regulation, Testimony Before the Committee on Financial Services of the U.S. House of Representatives (Nov. 4, 2015) (discussing the LISCC program).

The general framework for supervising LISCC firms is focused on four priority areas:

- capital adequacy and capital planning;
- liquidity sufficiency and resilience;
- corporate governance (assessing the effectiveness of senior management and the board of directors); and
- recovery and resolution planning.[137]

The Federal Reserve Board imposes the highest requirements and expectations on the LISCC firms in each of these priority areas.

OCC Action

The OCC has likewise taken a prominent role in the new era of bank supervision by adopting heightened supervisory standards for corporate governance of large national banks. In 2010 the OCC developed a set of heightened supervisory "expectations" to strengthen governance and risk management practices at large national banks. [138] One of the heightened expectations that the OCC articulated was the board's willingness to provide "credible" challenge to the management of the bank, meaning prudently questioning senior management on such matters as the propriety of strategic initiatives and on the balance between risk-taking and reward.[139] This level of engagement requires the board to devote sufficient time and energy in reviewing information and developing an understanding of the key issues related to the bank's activities.

Another theme stuck in the heightened expectations was the "sanctity of the charter."[140] As the OCC has explained, the bank charter is "a special corporate franchise that provides a gateway to federal deposit insurance and access to the [Federal Reserve] discount window."[141] Accordingly, the OCC regards "the primary fiduciary duty" of the board of directors to be ensuring "the safety and soundness of the national bank."[142] To protect the "sanctity" of the charter, a

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[137] *See* Large Institution Supervision Coordinating Committee at http://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm.

[138] *See* Thomas J. Curry, Comptroller of the Currency, Testimony before U.S. Senate Comm. on Banking, Hous., and Urban Affairs (June 6, 2012) [hereinafter Curry Testimony].

[139] *Id.* at 23.

[140] *Id.* at 25.

[141] *Id.* at 25–26. *See also* Remarks by Thomas J. Curry, Comptroller of the Currency, Before the Clearing House Second Annual Business Meeting and Conference 7 (Nov. 15, 2012).

[142] *Id.* at 25.

bank subsidiary cannot operate simply as a booking entity for the holding company.[143] Although many bank holding companies are managed on a line-of-business basis, the OCC expects that appropriate personnel, processes, and controls will be in place at the bank level to control and oversee the operations of the businesses at the bank. The directors of a bank subsidiary must be sensitive to the need for governance focused on the bank as a separate entity and on protecting the interests of the bank.

Still another theme struck in the heightened expectations was the board's role in defining and communicating risk tolerance across the firm.[144] Establishing risk limits solely at the business-unit level would not enable the senior management or the board to monitor or evaluate concentrations of risk or risk levels at the broader firm level. Finally, the heightened expectations regime elevated the expectation that the quality of audit and risk management would be "strong" rather than just "satisfactory" under the longstanding CAMELS rating system used by the federal banking agencies (discussed below).[145] This was a significant change in supervisory policy and expectation.

These heightened expectations were initially implemented through the examination process. But the OCC found that progress toward achieving these expectations through the examination process was too slow and that it needed to adopt a more robust approach, including the possibility of an enforcement response.[146] In 2014 the OCC took the additional step of publishing for public comment a set of guidelines establishing "heightened standards."[147] These guidelines were proposed as an appendix to the OCC Part 30 safety and soundness standards regulation. The purpose for proposing these standards under Part 30 was to establish the heightened expectations as minimum standards for the design and implementation of a risk governance framework at large insured national banks, federal savings associations and federal branches of foreign banks (*i.e.*, with consolidated assets of $50 billion or more) and minimum standards for board oversight of the design and implementation of the risk management framework. The effect of adopting these guidelines and standards under Part 30 would be to provide the OCC with the flexibility and

[143] *Id.* at 26.

[144] *Id.* at 24.

[145] *Id.* at 25.

[146] *See* Remarks by Thomas J. Curry, Comptroller of the Currency, Before the Prudential Bank Regulation Conference 4 (June 9, 2015) [hereinafter Curry Remarks].

[147] OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches, 79 Fed. Reg. 4,282 (proposed Jan. 27, 2014).

authority to enforce the guidelines and standards in the same manner as a regulation.[148]

The proposed guidelines and standards had two major sets of components. The first set of components set forth minimum standards for the design and implementation of a risk governance framework, along the lines of the commonly accepted structure of three lines of defense: front-line units, independent risk management, and internal audit. The proposed standards provided specific and highly prescriptive responsibilities for each of the three lines of defense as well as specific requirements for such other matters as the creation of a risk appetite statement, including both qualitative components and quantitative limits (to be approved by the board of directors), a risk appetite review, monitoring and communication process, and a process governing risk limit breaches.[149] The standards call for a risk management framework to be designed by an independent risk management function and approved by the board of directors or the risk committee of the board. The risk governance framework should include delegations of authority from the board of directors to management committees and executive officers as well as risk limits for material activities. The specificity of these standards for the design and implementation of a risk management framework must be seen in the context of the conclusions reached by the supervisory authorities as to the significant weaknesses in the risk management processes at the time of the financial crisis.[150]

The second set of components related to the standards for board oversight of

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[148] *Id.* at 4,284.

[149] *Id.* at 4,298–4,300. As one example of their prescriptive detail, the guidelines as finally adopted require a process to identify and communicate to the board significant instances where the chief executive officer is not adhering to, or holding front-line units accountable for adhering to, the risk governance framework. 79 Fed. Reg. at 54,547.

[150] *See, e.g.*, Senior Supervisors Group, *Risk Management Lessons from the Global Banking Crisis of 2008* (2009); Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* (2008); Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (2008). These reports observed significant differences in the strength and robustness of the risk management policies and practices among large financial firms. The firms with the weaker risk management policies and practices performed less well during the 2008 financial crises. *Id.* These latitudinal observations made in the midst of the crisis were confirmed by subsequent longitudinal studies that traced the risk management problems of certain large banks back to the 1998 financial crisis. *See, e.g.*, Andrew Ellul & Vijay Yerramilli, *Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies*, 68 J. FIN. 1757 (2013); Rüdiger Fahlenbrach, Robert Prilmeier & René M. Stulz, *This Time Is the Same: Using Bank Performance in 1998 to Explain Bank Performance During the Recent Financial Crisis*, 67 J. FIN. 2139 (2012). These studies confirmed the intuition

the heightened risk management framework. Among the minimum standards for the board's role was a "duty" to "ensure that the bank establishes and implements an effective risk-governance framework that meets the minimum standards described in [the] Guidelines."[151] Another minimum standard provided as follows:

> The bank's board of directors should actively oversee the bank's risk-taking activities and hold management accountable for adhering to the risk governance framework. In providing active oversight, the board of directors should question, challenge, and when necessary, oppose recommendations and decisions made by management that could cause the bank's risk profile to exceed its risk appetite or jeopardize the safety and soundness of the bank.[152]

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that robust risk management practices would help to mitigate adverse results in times of financial crisis.

Certain of these studies attributed less significance to board governance processes in assessing performance during the financial crisis. Indeed, in some cases the studies found a negative correlation between an accepted norm of "better" governance and performance during the financial crisis. *See, e.g.*, Andrew Beltratti & René M. Stulz, *The Credit Crisis Around the Globe: Why Did Some Banks Perform Better?*, 105 J. FIN. ECON. 1, 16 (2012) ("We find no support for analyses that attribute an important role to governance in the crisis since banks with more shareholder-friendly boards, which are banks that conventional wisdom would have considered to be better governed, generally fared worse during the crisis."); Bernadette A. Minton, Jérôme P. Taillard & Rohan Williamson, *Financial Expertise of the Board, Risk Taking, and Performance: Evidence from Bank Holding Companies*, 49 J. FIN. & QUANT. ANALYSIS 351 (2014) ("Financial expertise among independent directors of U.S. banks is positively associated with balance-sheet and market-based measures of risk in the run-up to the 2007–2008 financial crisis. While financial expertise is weakly associated with better performance before the crisis, it is strongly related to lower performance during the crisis."); Renée B. Adams & Hamid Mehran, *Bank Board Structure and Performance: Evidence for Large Bank Holding Companies* 3 (2011), available at http://ssrn.com/abstract=1945548 ("One potential cost of outsiders [as directors] is that they lack valuable firm-specific information, which some have argued has been a particular problem for banks during the financial crisis. . . . Thus, it is not clear that we should expect bank performance to increase in independence."). For a summary of the other studies raising questions about the effect of certain elements of "better" governance on the performance of banks during the financial crisis, see René M. Stulz, *Risk Management, Governance, Culture, and Risk Taking in Banks*, 22 FRBNY ECON. POL'Y REV. 43, 48 (2016) ("Existing empirical research does not seem to support the proposition that better governance in banks leads to less risk."). For a further discussion of the special considerations that apply to banks and other financial institutions in determining whether a particular norm of governance should be considered "good" governance or "bad" governance, see Christopher S. Armstrong et al., *The Role of Financial Reporting and Transparency in Corporate Governance*, 22 FRBN ECON. POL'Y REV. 107, 117–119 (2016).

[151] 79 Fed. Reg. at 4,300.

[152] *Id.*

The proposal drew significant comment on a wide range of issues from the banking industry. As to the role of the board, several comment letters objected to language in the preamble to the proposal that stated that "one of the primary fiduciary duties of an institution's board of directors is to ensure that the institution operates in a safe and sound manner."[153] Comment letters objected to the use of the word "ensure" with respect to a board's oversight responsibility because it might be read to imply that a board would need to be deeply involved in day-to-day activities of the bank.[154] The word also appeared to connote a guarantee of results. More fundamentally, the comment letters objected to the characterization of a duty to ensure that a banking institution operates in a safe and sound manner as a fiduciary duty. The comment letters suggested that such language could be read to create a new fiduciary duty in addition to the duty of care and the duty of loyalty.[155] Commentators also questioned the prominent role that the proposed standards gave to the board "challenging" management.

In adopting the final rule, the OCC deleted the language referring to the "duty" of the board to "ensure" that the bank establishes and implements an

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[153] *Id.* at 4,283.

[154] *See, e.g.,* Letter from The Clearing House Association to the Office of the Comptroller of the Currency 16 (March 28, 2014) [hereinafter Clearing House Letter]. The OCC has used the word "ensure" with reference to the oversight activities of a board in a number of other contexts such as in the 2010 Director's Book. *See, e.g.,* 2010 Director's Book, *supra* note 8, at 19 ("the board must oversee the bank to ensure that the bank operates in a safe and sound manner"). The Federal Reserve Board also uses the word "ensure" with respect to the oversight responsibilities of a board. *See, e.g., supra* text accompanying notes 125, 131 & 133. In light of the financial crisis, it is understandable that a director would be reluctant to assume the responsibility for "ensuring" anything (other than perhaps his or her attendance at board meetings). Industry groups continue to urge the regulators to use greater care in their formulation of the responsibilities of directors. *See, e.g.,* The Clearing House Association, The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations 17–18 (2016) (critiquing, for example, regulatory formulations that state that the boards should "ensure" specific outcomes or that boards should "establish" or "develop" policies or processes as opposed to providing oversight of policies or processes established or developed by management). It appears that industry comments led the OCC to revise certain of its formulations in the Director's Book with the elimination, for example, of certain references to the board "ensuring" certain outcomes. In response to industry comments, the OCC also added language in the Director's Book to emphasize that "the board's role in the governance of the bank is clearly distinct from management's role. The board is responsible for the overall direction and oversight of the bank—but is not responsible for managing the bank day-to-day." Director's Book, *supra* note 6, at 11. For a discussion of changes made by the OCC to the Director's Book to remove references to a fiduciary duty to depositors, see *supra* note 13.

[155] *See* Clearing House Letter, *supra* note 154, at 17.

effective risk governance framework and substituted language to the effect that the board should require the management to establish and implement an effective risk management framework and that the board should oversee (rather than "ensure") the bank's compliance with safe and sound banking practices. In explaining these changes, the OCC said it had not meant to impose managerial responsibilities on the board or to suggest that the board must guarantee results.[156]

As to the standard relating to effective challenge to management, the final rule included the following language:

> In providing active oversight, the board of directors may rely on risk assessments and reports prepared by independent risk management and internal audit to support the board's ability to question, challenge, and when necessary, oppose recommendations and decisions made by management that could cause the covered bank's risk profile to exceed its risk appetite or jeopardize the safety and soundness of the covered bank.[157]

In explaining this standard in the preamble to the final rule, the OCC said that it did not intend for the challenge standard to become a compliance exercise or to lead to board meetings becoming scripted events between management and the board. Instead, the OCC said that it intends to assess compliance with this standard primarily by engaging OCC examiners in frequent conversations with directors.[158] Discussion with a board is a general practice for OCC examiners and is already reflected in the OCC examination manual procedures for its examiners.[159]

The heightened standards also underscore the OCC's heightened expectations with respect to the amount of information that a board should digest and understand about the risks of financial institutions, generally, and its institution, in particular. In the preamble to the final rule, the OCC explained:

> During the financial crisis, the OCC observed that some members of the board of directors at certain institutions had an incomplete

[156] 79 Fed. Reg. at 54,537.

[157] *Id.* at 54,549.

[158] *Id.* at 54,538.

[159] *See, e.g.*, COMPTROLLER'S HANDBOOK, BANK SUPERVISION PROCESS 37–38 (2007); COMPTROLLER'S HANDBOOK, LARGE BANK SUPERVISION 20–21 (2010). *See also* DIRECTOR'S BOOK, *supra* note 6, at 6 ("Directors are encouraged to meet with OCC examiners to discuss the condition of the bank and the results of examination. Independent directors may choose to meet with OCC examiners without management's presence.").

> understanding of their institution's risk exposures. The OCC believes that this evidences both a failure to exercise adequate oversight of management and critically evaluate management's recommendations and decisions during the years preceding the financial crisis.[160]

To ensure that directors have the requisite background knowledge to understand the information they receive from management, the final rule (like the proposed rule) includes a requirement that a bank establish a formal, ongoing training program for its directors that focuses on areas relevant to the bank.[161] The preamble explains that OCC examiners will evaluate each director's knowledge and experience, as demonstrated in a written biography and in discussion with examiners.[162] The final rule (like the proposed rule) also contains a requirement that the bank board conduct an annual self-assessment that includes its effectiveness in meeting the heightened standards in the rule. An annual board self-assessment is now widely regarded as a best practice. In its recent reissuance of the Director's Book, the OCC has expanded the discussion of the importance of risk management and the role of the board in overseeing a risk management framework, referring to the heightened standards now codified in Part 30.

The heightened standards adopted under Part 30 represent a significant enhancement of the supervisory regime for large national banks. In the words of the Comptroller of the Currency, they represent a "complete rethinking of how we supervise our largest and most complex banks, particularly those that pose the greatest systemic risks."[163] The heightened standards as implemented by the OCC in its examination process embrace corporate governance with something approaching a religious fervor. In the broadest sense, the heightened standards seek to protect the "sanctity" not just of the national bank charter, but also of the national banking system. The heightened standards also reflect a renewed reliance on a basic article of faith among bank regulators, namely, that active oversight by a board can effectively modulate risk taking in individual banking institutions. As discussed in the next section, this article of faith is one of the pillars of the traditional bank supervisory approach.

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[160] 79 Fed. Reg. at 54,537.

[161] *Id.* at 54,539.

[162] *Id.*

[163] Curry Remarks, *supra* note 146, at 4.

THE TRADITIONAL BANK SUPERVISORY REGIME

Examination and Rating Process

The enhanced regulatory regime put in place by the Dodd-Frank Act and the "heightened standards" implemented by the OCC build upon a basic supervisory infrastructure that has been in place for many years. The federal banking agencies continue to apply traditional supervisory practices and techniques in their oversight of banking institutions. Of the traditional bank supervisory practices the most prominent and important is the examination process for banking institutions.[164] Closely aligned with the examination process is the practice of installing resident examiners on a full-time basis at the largest banking institutions (although this particular practice has recently come under scrutiny).[165] The traditional mantra of bank supervision continues to apply, namely, that banking institutions should operate in a safe and sound manner in compliance with applicable law and regulations. In recent decades as banking institutions have expanded in product lines, geographies, and complexity, the supervisory process has come to emphasize a risk-focused examination approach.[166] The risk-focused examination approach places a special emphasis on evaluating the internal risk management, control, and governance processes of the banking institution itself as safeguards for the institution and now for systemically important banking institutions as safeguards for the financial system as a whole. The examination process assesses how well a banking institution is responding to the new regulatory requirements and enhanced supervisory expectations arising from the Dodd-Frank Act and the experience of the financial crisis. At the same time, the examination process continues to assess traditional safety and soundness risks and compliance with longstanding laws and regulations.

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[164] *See, e.g.*, Curry Testimony, *supra* note 138, at 17–19.

[165] *See id.* at 17. *See* Katy Burne, *New York Fed Pulling Examiners Out of Banks*, WALL ST. J. C 1 (July 29, 2016) (reporting that the Federal Reserve Bank of New York is moving resident examiners out of offices at the large banks that they supervise out of a concern that resident examiners have grown too close to the banks they supervise). *See also* Thomas M. Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation, Remarks on Bank Supervision to the Federal Reserve Bank of New York, Conference on Supervising Large Complex Financial Institutions 2 (Mar. 18, 2016) (noting the risk that on-site examiners may sometimes identify with management decisions).

[166] *See, e.g.*, COMPTROLLER'S HANDBOOK, BANK SUPERVISION PROCESS 1–2 (2007); Board of Governors of the Federal Reserve System, SR 97-24 (SUP), *Risk-Focused Framework for Supervision of Large Complex Institutions* (Oct. 27, 1997).

To assist in meeting these challenges, the federal banking agencies have for many years "codified" their examination process in examination manuals. The Federal Reserve Board, for example, has a Bank Holding Company Supervision Manual (the "BHC Supervision Manual") for the examination of bank holding companies. The Federal Reserve Board also has a Commercial Bank Examination Manual, a Trading and Capital-Markets Activities Manual and a Consumer Compliance Handbook for the examination of state member banks. The examination manuals issued by the Federal Reserve Board, and the comparable examination manuals issued by the OCC and the FDIC, are the bibles of the bank examiners. Fittingly, they are of biblical proportions. The BHC Supervision Manual and the Commercial Bank Examination Manual, for example, are each in excess of 1,900 pages in length.

As discussed in Part I of this article and as further discussed below, the Federal Reserve Board, the OCC, and the FDIC have issued extensive supervisory guidance imposing responsibilities on boards of banking institutions. These guidance documents are in addition to statutes and regulations that impose responsibilities on directors. The American Association of Bank Directors (the "AABD") in its *Bank Director Regulatory Burden Report* identified, for example, 140 provisions in Federal Reserve Board guidance documents imposing responsibilities on boards of state member banks and 33 provisions in Federal Reserve Board guidance documents imposing responsibilities on boards of bank holding companies.[167] The AABD Report identified 225 examples of OCC guidance imposing responsibilities on boards. The Clearing House in a report issued in May 2016 identified a similarly large number of instances where guidance documents impose responsibilities on boards or committees of boards.[168] The examination manuals used by the Federal Reserve Board, the OCC, and the FDIC are intended to incorporate these laws, regulations and guidance documents and to guide the examiners in their assessment of the conformity of practices in the individual banking institutions with these requirements. Establishing the level of conformity with these laws, regulations and supervisory guidance documents by the individual institution is an important part of the examination process. Although the examination manuals generally state that examiners may exercise a measure of discretion in applying guidance documents in the examination process, examiners tend to apply guidance documents in a rigid and prescriptive manner.

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[167] DAVID BARIS & LOYAL HORSLEY, AMER. ASS'N OF BANK DIRS., BANK DIRECTOR REGULATORY BURDEN REPORT 16 (2014) [hereinafter AABD REPORT].

[168] THE CLEARING HOUSE, THE ROLE OF THE BOARD OF DIRECTORS IN PROMOTING EFFECTIVE GOVERNANCE AND SAFETY AND SOUNDNESS FOR LARGE U.S. BANKING ORGANIZATIONS (2016) [hereinafter 2016 CLEARING HOUSE REPORT].

The foreword to the Federal Reserve Board's Commercial Bank Examination Manual provides a succinct description of the objectives of the examination process:

> (1) to provide an objective evaluation of a bank's soundness, (2) to determine the level of risk involved in the bank's transactions and activities, (3) to ascertain the extent of compliance with banking laws and regulations, (4) to permit the Federal Reserve to evaluate the adequacy of corporate governance and to appraise the quality of the board of directors and management, and (5) to identify those areas where corrective action is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, regulations and supervisory policies and guidance.[169]

The product of the examination process is an examination report with a rating for the institution. The Commercial Bank Examination Manual contains a description of rating system used in the examination process, the so-called CAMELS rating system. The CAMELS rating formula is based on a supervisory assessment of the following components:

> (1) [the] quality and adequacy of the bank's capital (C); (2) the quality of the bank's assets (A); (3) the capability of the board of directors and management (M) to identify, measure, monitor, and control the risks of the bank's activities and to ensure that the bank has a safe, sound, and efficient operation that is in compliance with applicable laws and regulations; (4) the quantity, sustainability, and trend of the bank's earnings (E); (5) the adequacy of the bank's liquidity (L) position; and (6) the bank's sensitivity (S) to market risk.[170]

Each of these five components is assigned a rating from 1 to 5 from which a composite rating is then derived. The CAMELS rating scale is from 1 (indicating strongest performance and risk management practices) to 5 (indicating the weakness performance and highest degree of supervisory concern). A rating of 3 on management is less than satisfactory and invokes significant supervisory consequences for the bank. The quality of management (which includes both the board of directors and senior management) is generally regarded as the single most important element in the operation of a banking institution.[171] An institution with a satisfactory examination rating on such components as capital and earnings may nonetheless receive an unsatis-

[169] Commercial Bank Examination Manual, *supra* note 12, Foreward at 1 (2010).

[170] *Id.* at 1–2.

[171] *See, e.g.*, Comptroller's Handbook, Bank Supervision Process 94 (2007).

factory composite rating if, for example, the management and board of directors receive an unsatisfactory rating because of significant compliance problems.

The Commercial Bank Examination Manual provides the key elements of the risk management framework that are to be analyzed in the examination process. The first element is active board and senior management oversight.[172] In assessing this element, the Commercial Bank Examination Manual directs the examiners to consider whether the banking institution follows policies such as the following:

- The board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution's activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk management practices, and the institution's activities evolve;
- The board has reviewed and approved appropriate policies to limit risks inherent in the institution's lending, investing, trading, trust, fiduciary, and other significant activities or products;
- The board and management are sufficiently familiar with and are using adequate record-keeping and reporting systems to measure and monitor the major sources of risk to the organization; and
- The board periodically reviews and approves risk-exposure limits to conform with any changes in the institution's strategies, reviews new products, and reacts to changes in market condition.[173]

The other 1900 pages of the Commercial Bank Examination Manual describe in detail the statutory, regulatory and supervisory requirements applicable to the individual business activities of the banking institution and the examination techniques that are to be used in making the overall assessment of the conduct of the activities by the banking institution.

As noted above, the Federal Reserve Board also has a BHC Supervision Manual for use in the examination of bank holding companies. Like the Commercial Bank Examination Manual, the BHC Supervision Manual emphasizes the importance attached to the governance process. It begins with an overarching statement of objectives of the Federal Reserve Board's supervision of large complex bank holding companies:

> One of the primary areas of focus for consolidated supervision of large

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[172] COMMERCIAL BANK EXAMINATION MANUAL, *supra* note 12, § 1000.1 at 4.7 (2015).

[173] *Id.*

> complex bank holding companies is the adequacy of governance provided by the board and senior management. The culture, expectations, and incentives established by the highest levels of corporate leadership set the tone for the entire organization and are essential determinants of whether a banking organization is capable of maintaining fully effective risk-management and internal control processes. The board and its committees should have an ongoing understanding of key inherent risks, associated trends, primary control functions, and senior management capabilities.[174]

The BHC Supervision Manual then recites the basic directive that "the Federal Reserve will understand and assess the adequacy of oversight provided by the board and senior management" and that continuous monitoring and surveillance activities will be used "to understand and assess the effectiveness of board and senior management resources and oversight."[175]

The Federal Reserve Board uses a rating system for a bank holding company that is similar to, but distinct from, the CAMELS rating system used by the federal banking agencies for the bank subsidiaries of a holding company.[176] The bank holding company rating system is designed to provide an assessment of risk management and financial condition factors relevant to the holding company and its nondepository subsidiaries as well as an assessment of the potential impact of the parent bank holding company and its nondepository subsidiaries on the bank subsidiaries of the holding company. A bank holding company is assigned a composite rating (C) based on an overall evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary banking institution. The main components of the rating system consist of: risk management (R); financial condition (F); and impact (I) of the nondepository subsidiaries on the bank subsidiaries. A fourth rating, Depository Institution(s) (D), will generally mirror the primary federal banking regulator's rating for the bank subsidiary. The primary component and composite ratings are presented in examination reports as follows: RFI/C(D). The R component represents an overall assessment of the ability of the board of directors and senior management, as appropriate for their respective positions, to identify, measure, monitor and control risk in the institution. The R component is supported by four subcomponents. The subcomponents are: board and senior management oversight; policies, procedures, and limits; risk

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[174] Board of Governors of the Federal Reserve System, Bank Holding Company Supervision Manual [hereinafter BHC Supervision Manual], § 1050.1.3.1.1 at 3 (2015).

[175] *Id.*, § 1050.1.3.1.1 at 4.

[176] *Id.*, § 4070.0.1 (2015).

monitoring and management information systems; and internal controls. Like the CAMELS rating system, the bank holding company rating system is based on a scale of 1 (strongest) to 5 (weakest).

COMMUNICATION OF SUPERVISORY CONCERNS TO A BOARD

The BHC Supervision Manual and the Commercial Bank Examination Manual indicate that the communication of supervisory findings to the board of directors of a banking institution is an important part of the supervision of the institution:

> While the board itself 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.[177]

Depending upon the size and complexity of the banking organization, supervisory findings will be communicated in writing through formal examination or inspection reports, reports summarizing the results of targeted reviews, a roll-up of those reviews into a comprehensive report, or a combination of these. These written communications are generally directed to the board of directors, or an executive-level committee of the board, as appropriate. In turn, the board of directors (or executive-level committee of the board) will direct the organization's management to take corrective action and will provide management with appropriate oversight, including approvals of proposed management actions as necessary.[178]

There are two principal categories of supervisory matters for communication to a board: Matters Requiring Immediate Attention ("MRIAs") and Matters Requiring Attention ("MRAs"). The Federal Reserve Board describes MRIAs as:

> matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include: (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization; and (4) in the case

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[177] *Id.*, § 5000.0.9.3 at 17 (2014).

[178] *Id.*

of consumer compliance examinations, matters that have the potential to cause significant consumer harm.[179]

MRAs are matters requiring correction that a banking institution is expected to address not immediately but over a reasonable period of time. The banking institution's board of directors is required to respond to the Federal Reserve Bank in writing regarding the corrective action taken or planned along with a commitment to the corresponding time frame for the corrective action for MRIAs and MRAs.[180]

Examiners are required to follow up on MRIAs and MRAs as part of standard supervisory practice. Thus, there is a further monitoring process built into the standard supervisory procedure. If the examiner's follow up indicates that the banking institution's corrective action, particularly on MRIAs, has not been timely or otherwise satisfactory, the initiation of a formal or informal enforcement action against the banking institution may be considered by the federal banking agency.[181] If a formal enforcement action is taken, the enforcement action will typically require periodic reporting, typically on a quarterly basis, of the progress being made by the banking institution in correcting the compliance or other risk management problem. The board or a committee of the board is generally required to provide this periodic report, emphasizing the role that the federal banking agencies ascribe to the board in addressing such problems.[182]

The failure to maintain a satisfactory rating on the management component of a CAMELS rating or on the risk management component of the RFI(C)(D) rating has significant regulatory consequences for a banking institution. The Gramm-Leach-Bliley Act allows a bank holding company to qualify for "financial holding company" status, meaning that the bank holding company and its affiliates may engage in a much broader range of financial and investment activities than those previously authorized for a bank holding company or its affiliates. To qualify for financial holding company status, the bank holding company and each depository subsidiary of the bank holding company must be and remain "well capitalized" and "well managed" as those terms are defined in the BHCA.[183] A bank holding company or a depository subsidiary of that company would not be deemed to be "well managed" if it

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[179] *Id.*, § 5000.0.9.3 at 18.

[180] *Id.*

[181] *Id.* at 18–19.

[182] *Id.*

[183] 12 U.S.C. § 1841(o)(1) & (9); 12 U.S.C. § 1843(k)(1) & (ℓ)(1) & (2) (2014).

does not have a satisfactory composite rating and a satisfactory rating on management (if such a rating is given). A bank holding company that fails to continue to qualify for "well managed" status becomes subject to various restrictions, including a limitation on engaging in new financial activities or acquiring new financial investments, until the rating is restored to a satisfactory status. The management and board of a bank holding company have a strong incentive to maintain a satisfactory composite and management rating.

If a bank holding company or any of its depository subsidiaries fails to maintain its "well capitalized" or "well managed" status, the bank holding company must enter into an agreement (referred to informally as a "4(m) agreement" for the section of the BHCA from which it derives) with the Federal Reserve Board, prescribing the actions that the bank holding company will take to correct the areas of noncompliance.[184] The Federal Reserve Board does not publicly disclose the fact that a bank holding company or any of its depository subsidiaries has failed to maintain its "well managed" status or the fact that the bank holding company has entered into an agreement to correct the areas of noncompliance. The consequences from a business perspective can still be significant, particularly in respect of foregone opportunities.

As noted above, there may also be circumstances that will lead the Federal Reserve Board to take a public enforcement action, such as a written agreement or cease and desist order, against a bank holding company for risk management or, even more likely, compliance problems. Such an enforcement action may by its terms require that the board of directors, or a committee of the board such as a compliance committee, take specific oversight responsibility for addressing the problem and implementing a remediation program. As the commentary to the Clearing House Guiding Principles notes, when a banking organization is subject to an enforcement action by the regulators, the directors may be required to oversee "in a more active manner" the implementation of corrective actions and the organization's compliance with the enforcement action.[185]

ENHANCED DIALOGUE WITH A BOARD

The financial crisis has brought a heightened supervisory focus on corporate governance, particularly for the largest most complex banking institutions. An important aspect of that heightened focus is the heightened standards for board oversight of risk management processes in these institutions. In adopting its heightened standards the OCC has intentionally raised the bar for the directors

[184] 12 C.F.R. § 225.83(c) (2016).

[185] Clearing House Guiding Principles, *supra* note 36, at 13.

of large banks.[186] One of the ways that the regulators are encouraging and measuring a board's commitment to these heightened standards is increased interaction with members of the board.[187] The traditional bank supervisory regime envisions communication and interaction between the regulators and the board as one of its features, although typically as incident to the annual examination process. The 2010 DIRECTOR'S BOOK provides an overview of this traditional approach:

> Examiners meet with bank management during the examination to obtain information or to discuss issues. When the examination is complete, the examiners prepare a report of examination and conduct a meeting with the bank's board of directors . . . to discuss the results of the examination. Each director is responsible for thoroughly reviewing and signing the report of examination.[188]

The DIRECTOR'S BOOK as revised in 2016 now envisions more frequent and interactive engagement between the examiners and the boards of the largest national banks.[189]

The Federal Reserve board has traditionally pursued a similar approach to interaction with the board, again generally as incident to the examination process. The Commercial Bank Examination Manual provides the following general description of its approach:

> The board of directors plays an essential role in the management of a bank's operations and is directly responsible for the soundness of the bank. As a result, in some cases, it is useful for Federal Reserve examiners and/or officers to meet with boards of directors. These meetings provide examiners with the opportunity to inform directors of examination findings, discuss the bank's plans and prospects with the board, and highlight important supervisory issues, particularly in cases that may require initiation of informal or formal supervisory actions. Meetings with boards of directors also provide examiners with

[186] *See* Remarks by Thomas J. Curry, Comptroller of the Currency, Before the Clearing House Second Annual Business Meeting and Conference 5 (Nov. 15, 2012).

[187] *See, e.g.*, 79 Fed. Reg. at 54,538 (noting that "the OCC intends to assess compliance with the [challenge] standard primarily by engaging OCC examiners in frequent conversations with directors").

[188] 2010 DIRECTOR'S BOOK, *supra* note 8, at 7. *See also* COMPTROLLER'S HANDBOOK, LARGE BANK SUPERVISION, at 20 ("the OCC uses board meetings to discuss how the board should respond [to] supervisory concerns and issues").

[189] DIRECTOR'S BOOK, *supra* note 6, at 4–6.

> a limited opportunity to ascertain the directors' knowledge of and interest in the bank's operations.[190]

As a qualification on this general statement, the Commercial Bank Examination Manual indicates that a meeting with the board is required to be held after every full-scope examination of a multinational organization or major regional organization (with assets in excess of $5 billion).[191] Federal Reserve Board policy also requires that a meeting be held with the board of any organization that has significant problems.[192] A meeting with the board would also be required if the bank is entering into a memorandum of understanding or other formal enforcement action or is already operating under a supervisory action but is not in compliance with significant provisions in the supervisory action.[193] These traditional norms for interaction with the board may best be described as reactive, rather than proactive. These traditional norms have given way to a much more robust and proactive approach to regulatory and supervisory interaction with boards of directors, particularly those of large complex banking institutions.

Weak corporate governance at certain systemically important financial institutions was perceived to be one of the contributing factors to the global financial crisis in 2007–2009. In response to that perception, the Group of Thirty has taken a leading role in the discussion of corporate governance. In a report published in 2012, *Toward Effective Governance of Financial Institutions*, the Group of Thirty laid out a series of recommendations for management, boards, supervisors and shareholders to enhance corporate governance.[194] As a follow-on to the 2012 report, the Group of Thirty in 2013 published an additional report, entitled *A New Paradigm: Financial Institution Boards and Supervisors*.[195] This report proclaims that "it is time to create a new paradigm for interaction between supervisors and boards of major financial institutions."[196] The report, based on an extensive interview process with senior supervisors and board members of large complex banks, observes that relations

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[190] COMMERCIAL BANK EXAMINATION MANUAL, *supra* note 12, § 5030.1 at 1 (1995).

[191] *Id.* at 3.

[192] *Id.* at 2 (indicating that a bank is regarded to have significant problems if it is assigned a CAMELS composite of 4 or 5 or if a bank is assigned a CAMELS composite rating of 3 and its condition appears to be deteriorating or is showing little improvement).

[193] *Id.* at 3.

[194] GROUP OF THIRTY, TOWARD EFFECTIVE GOVERNANCE OF FINANCIAL INSTITUTIONS (2012).

[195] GROUP OF THIRTY, A NEW PARADIGM: FINANCIAL INSTITUTION BOARDS AND SUPERVISORS (2013).

[196] *Id.* at 5.

between boards and supervisors generally are not optimum although some supervisors and banks have started to implement a new paradigm for their relations.[197] The report offers practical recommendations for improving communication and trust between senior supervisors and board members, but with the caution that the new paradigm it recommends will require a "substantial increased time commitment from many board members and supervisors."[198] The thrust of the Group of Thirty report reflects the experience of regulators, such as the Federal Reserve Bank of New York, which in 2011 initiated its own program of "enhanced engagement" with the senior management and directors of the large firms that it supervises.[199] That experience provided useful insights as to the acclimation process necessary for both the supervisor and the supervised. For the supervisor, it meant delivering clearer and more timely supervisory guidance to the firm. For the senior managers and directors of the supervised entity, it meant a "shift toward greater openness and increased candor with the supervisors."[200]

Industry groups, most notably the Clearing House, have taken up the call by the Group of Thirty to strengthen the interaction between supervisors and boards. The Clearing House Guiding Principles provide that the board (or specified directors) should try to meet at least twice a year with the principal regulators of the banking organization and should advise each principal regulator that the board or specified directors are prepared to meet with the principal regulator, including in executive session, whenever the regulator requests.[201] The commentary to the Clearing House Guiding Principles recognizes that the board should consider whether, in addition to meetings with the full board, the regulators should meet separately with the lead independent director or relevant committee chairs.[202] While the commentary to the

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[197] *Id.*

[198] *Id.*

[199] *See* Sarah Dahlgren, Executive Vice President of the Federal Reserve Bank of New York, More Resilient, Better Managed, Less Complex: Strengthening FMUs and Linkages in the System, Remarks at the Securities Industry and Financial Markets Association Conference (April 30, 2014).

[200] *Id. See also* Sarah Dahlgren, Executive Vice President of the Federal Reserve Bank of New York, The New Era of Supervision: Progress to Date and the Road Ahead, Remarks at the New York Bankers Assn. Annual Meeting (Nov. 5, 2014) ("When we, as supervisors, first began requiring deeper engagement with directors and senior leaders, the reactions varied, with an initial wariness of purpose. Over time, though, as senior leaders and board members recognized the advantages of this level of engagement, the process has become smoother . . .").

[201] CLEARING HOUSE GUIDING PRINCIPLES, *supra* note 36, at 9.

[202] *Id.* at 45.

Clearing House Guiding Principles recognizes that a meeting with regulators during or at the conclusion of the annual examination process is beneficial, it recommends that a board should not limit its contact with its principal regulator only to the examination process.[203] In addition, it observes that meetings with the local examination team in advance of meetings with the principal regulator may assist in the communication process.[204] The commentary to the Clearing House Guiding Principles also recognizes that when a banking organization is subject to an enforcement order, an enhanced level of oversight by the board and interaction with the regulators may be required.[205] The Clearing House Guiding Principles promote the kind of active and open dialogue that the Group of Thirty sees as essential to the new paradigm.

Some academic observers have raised the question whether the regulators' scrutiny of a bank may lull the directors into providing less scrutiny of their own of the bank.[206] The regulators of course do not intend that result and their demand for heightened standards of oversight by the board will mean that directors cannot easily default to a less diligent mode of oversight. The commentary to the Clearing House Guiding Principles also addresses this issue. It confirms the independent responsibilities of the directors to provide oversight of the banking organization.[207] The heightened standards and expectations of the federal banking regulators have already led to heightened oversight by the boards of the largest banking institutions. This heightened oversight by boards complements the heightened scrutiny that the federal banking regulators themselves are applying. While neither board oversight nor regulatory scrutiny obviously is foolproof, it is reasonable to expect benefits from heightened attention from both sources and heightened interaction between both sources.

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[203] *Id.* at 46.

[204] *Id.*

[205] *Id.* at 13 & 46.

[206] *See, e.g.*, Renée Birgit Adams, *Governance and the Financial Crisis*, 12 INT'L REV. FIN. 7, 13 (2012) ("The presence of a regulator raises the question of whether regulatory scrutiny complements or substitutes for board-level governance. There is as yet no satisfactory answer to this question."). *See also* Adams & Mehran, *supra* note 9, at 124 (discussing the view that regulatory oversight of an industry might substitute for corporate oversight or diminish the rigor of corporate oversight).

[207] CLEARING HOUSE GUIDING PRINCIPLES, *supra* note 36, at 46:

> It is important to recognize that the reviews by bank examiners do not diminish the board's responsibilities to oversee the management and operation of the banking organization. Directors are independently responsible for obtaining information from management as to the condition of the organization and should not rely on the examiners as their principal source of information to identify or correct problems.

The Group of Thirty report makes the case that well-informed interaction between supervisors and boards will result in a mutual reinforcement of their efforts. Although prudence counsels against putting it near the top of the agenda for discussion with the regulators, once a productive dialogue has been commenced, the burden imposed on directors by the large body of supervisory requirements might also be added as a topic for discussion.

A VAST INVENTORY OF RESPONSIBILITIES

As noted above, the AABD has undertaken a comprehensive review of federal statutory, regulatory and supervisory materials relating to the responsibilities of bank and bank holding company directors.[208] In its 2014 report, the AABD identified at least 143 provisions in federal banking law or other federal law imposing duties on the directors of banking institutions.[209] The AABD Report also noted at least 50 provisions in OCC regulators, 37 provisions in Federal Reserve Board regulations, and 38 provisions in FDIC regulations imposing requirements on the boards of the respective banking institutions that they supervise.[210] The AABD Report also reviewed the various sources of supervisory guidance, such as examination manuals, bulletins, circulars and supervisory letters issued by the federal banking agencies, to catalogue the guidance documents that impose responsibilities on directors of banks or bank holding companies. The AABD found over 225 provisions in OCC guidance documents, 180 provisions in FDIC guidance documents, and 140 provisions in Federal Reserve Board guidance documents imposing responsibilities on bank directors, with an additional 33 provisions in Federal Reserve Board guidance documents imposing responsibilities on the directors of bank holding companies.[211]

The AABD has stated its view of the consequences of this regulatory and supervisory approach:

> AABD is concerned that this morass of laws, regulations and guidance in the aggregate creates a huge and counterproductive impact on bank

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[208] AABD Report, *supra* note 167.

[209] *Id.* at 16.

[210] *Id.*

[211] *Id.* These figures are generally not additive. Many of the regulations and guidance documents cover the same topics but are issued by the federal banking agency with regulatory responsibility for the respective category of institution, *i.e.*, the OCC for national banks, the Federal Reserve Board for state member banks, and the FDIC for insured nonmember state banks.

> directors that unavoidably causes them to divert their attention away from the essential job of being a bank director—meeting their duty of care and loyalty by overseeing, not managing, the institution—and instead to devote valuable time to the inconsequential or matters that should be properly delegated to management.[212]

This body of laws, regulations and guidance generally applies in the ordinary course of business of a bank or bank holding company. As the AABD Report also noted, "[a]dditional burdens are faced by directors of the numerous banks that become subject to banking agency enforcement actions, who face formidable challenges to meet the requirements of those actions, including the risk of civil money penalties for noncompliance."[213]

The Clearing House has recently completed its own comprehensive review of statutory, regulatory and supervisory sources relating to the responsibilities of directors of banks and bank holding companies.[214] The Clearing House review included not only the three federal banking agencies (the OCC, the FDIC, and the Federal Reserve Board), but also the Federal Financial Institutions Examination Council and the Consumer Financial Protection Bureau. The 2016 Clearing House Report is even comprehensive and in many respects more detailed in its listing of the regulatory and supervisory requirements imposed on the directors of banks and bank holding companies than the AABD Report.

Together the AABD Report and 2016 Clearing House Report provide a detailed picture of the extraordinary burden imposed on directors of banking institutions. It is a burden unmatched in any other sector (whether regulated or not) of the corporate world. These reports reflect what has been a standard supervisory practice, ennobled by time, *i.e.,* to assume that every new issue of regulatory or supervisory concern requires board attention and becomes a board responsibility to address. The constant accretion of new issues into what has become a nondepletable inventory of issues for board oversight has inevitably resulted in an overload on board time, attention and resources. The sheer breadth and depth of the supervisory expectations are remarkable for any industry, even a regulated one.

The AABD Report and 2016 Clearing House Report also confirm the conclusion that in many instances regulatory and supervisory requirements have imposed management-like functions on board members. Indeed, the reports support the conclusion that the regulators have in many instances

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[212] *Id.* at 18.

[213] *Id.*

[214] *See* 2016 Clearing House Report, *supra* note 168.

imposed on directors the duty not simply to manage aspects of the business of a bank, but actually to micromanage aspects of the business. The examples cited in the AABD Report, such as the requirement for the board to review overdrafts or the basis for service charges on dormant accounts or to designate a security officer to develop and administer a security program for each banking branch, provide compelling evidence that the regulators have in effect imposed on directors responsibility for day-to-day management of various aspects of a firm's business.[215] Other examples of guidance documents imposing management responsibilities on boards abound. As noted in the 2016 Clearing House Report, OCC guidance indicates that a board of directors should formulate policies and procedures, including dollar limits, for the purchase and sale of commemorative coins by a national bank and for the consignment of other customer items.[216] Similarly, OCC guidance indicates that after real estate acquired by a bank for future expansion has been held for a year, the board must adopt a resolution detailing the plans for its future use.[217] OCC guidance also provides that the board must review and approve the charge-off of all loans.[218] An OCC regulation requires the board of a bank to review and schedule its banking hours.[219] Each of these examples reflects a pattern of imposing on boards responsibilities that are appropriately imposed on management.

The constant growth of this body of regulatory and supervisory requirements for board oversight reflects a failure by the regulators to effectively reconsider the history and development of issues that, as they have matured, should be downgraded from requiring specific board attention and relegated instead to ongoing management attention. It is imperative for the bank regulators to regularly review this inventory of issues to remove issues that have sufficiently aged in the experience of the board and management so that the attention of the board can be turned to the emergence of new issues that require heightened attention by the board. Cybersecurity is an obvious example of a relatively new issue that necessarily requires heightened attention from the management and the board.

The bank regulators should also prioritize the issues that remain in the inventory. There is obviously a constraint on the regulators for matters that by statute are expressly allocated to board review and approval. However, where a

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[215] AABD Report, *supra* note 167, at 19.

[216] 2016 Clearing House Report, *supra* note 168, Annex A at 42.

[217] *See id.* at 48.

[218] *See id.* at 46.

[219] *See id* at 11.

specific matter is not allocated to board review and approval by statute, the bank regulators should exercise their discretion to prioritize the matters that they expect will require the highest level of board attention and time. In effect, the bank regulators should use their supervisory discretion to facilitate the exercise of business judgment by the directors of a bank or bank holding company to prioritize these issues.

As a more ambitious agenda, the bank regulators should take the opportunity afforded by the decennial review required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("EGRPRA") to review and remove or revise regulations imposing board review and approval requirements that are unnecessary or unduly burdensome. In the last decennial review in 2006, the federal banking agencies asked for comment on four regulations covering directors.[220] In a 2014 comment letter to the federal bank regulators, the AABD criticized the fact that the federal banking agencies had asked for comment on only four regulations in their 2006 review and concluded that the 2006 review was flawed from the perspective of bank directors because many regulations and guidance documents were ignored in the review process.[221] As part of the current EGRPRA review process, the AABD has again requested that the federal banking agencies include guidance documents in their EGRPRA review because "[r]egulatory guidance is often enforced as if they are statutes or regulations."[222]

There has been some public acknowledgment by the federal regulators of the unnecessary burden being imposed on directors, particularly in an era when the regulators should wish to maximize the focus of directors on the most critical issues facing the banking industry. In a speech in 2014, Federal Reserve Board Governor Daniel Tarullo noted the challenges that boards face:

> There are many important regulatory requirements applicable to large financial firms. Boards must of course be aware of those requirements and must help ensure that good corporate compliance systems are in

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[220] *See* Request for Burden Reduction Recommendations: Rules Relating to Banking Operations; Directors, Officers and Employees; and Rules of Procedure; Economic Growth and Regulatory Paperwork Reduction Act of 1996 Review, 70 Fed. Reg. 46,779 (Aug. 11, 2005). The specific regulations related to indemnification payments to directors, extensions of credit to directors and interlocks by directors as well as Part 7 of the OCC regulations relating to corporate practices.

[221] *See* Letter from David Baris, President, & Richard Whiting, Executive Director of the AABD, to OCC, Federal Reserve Board, & FDIC (Sept. 2, 2014).

[222] *See* Letter from David Baris, President, & Richard Whitney, Executive Director of the AABD, to Chairperson of the Federal Reserve Board Janet Yellen (Jan. 28, 2016).

> place. But it has perhaps become a little too reflexive a reaction on the part of regulators to jump from the observation that a regulation is important to the conclusion that the board must certify compliance through its own processes. We should probably be somewhat more selective in creating the regulatory checklist for board compliance and regular consideration.[223]

Governor Tarullo followed this acknowledgment with a single example:

> One example, drawn from Federal Reserve practice, is the recent supervisory guidance requiring that every notice of a "Matter Requiring Attention" (MRA) issued by supervisors must be reviewed, and compliance signed off, by the board of directors. There are some MRAs that clearly should come to the board's attention, but the failure to discriminate among them is almost surely distracting from strategic and risk-related analyses and oversight by boards.[224]

Greater discrimination relating to the treatment of MRAs is surely necessary and appropriate. But what of the other 173 provisions in Federal Reserve Board guidance documents identified by the AABD as imposing oversight or other responsibilities on directors or the similarly large number of guidance documents identified by the Clearing House in its recent report? Governor Tarullo's use of a single example provides no sense of the scale of the problem presented by the vast body of supervisory guidance that imposes responsibilities on directors.

The federal bank regulators do periodically review their general supervisory guidance for outdated or superseded items. The Federal Reserve Board for instance periodically reviews its Supervision and Regulation (SR) Letters to determine whether they have become outdated or superseded by subsequent regulations, policies or guidance in the BHC Supervision Manual or the Commercial Bank Examination Manual. Its most recent review was completed in April 2016 and resulted in 78 Supervision and Regulation Letters (the earliest of which was issued in 1968) being declared inactive.[225] It does not appear, however, that any of the Supervision and Regulation Letters that were declared inactive related directly to responsibilities or duties imposed on directors. The Federal Reserve Board review process may have depleted

[223] Daniel K. Tarullo, Corporate Governance and Prudential Regulation, Speech at the Association of American Law Schools 2014 Midyear Meeting 6 (June 9, 2014).

[224] *Id.*

[225] *See* Board of Governors of the Federal Reserve System, SR 16-9, *Inactive Supervisory Guidance* (April 21, 2016).

outdated or superseded pieces of guidance from the general inventory of guidance documents, but it has not depleted the inventory of guidance documents that directly impose responsibilities on directors. That inventory continues to grow. A review specifically directed at the guidance documents identified in the AABD Report and the 2016 Clearing House Report should be undertaken. That review should be guided by the principles outlined in the 2016 Clearing House Report. The overriding principle of that review should, in the words of the 2016 Clearing House Report, be that "for most large U.S. banking organizations the vast majority of policies and procedures that govern day-to-day operations of businesses" should not require board review and approval.[226] Acceptance of this principle would represent a significant improvement on current supervisory practice.

CONCLUSION

The breadth and depth of the regulatory monitoring function for large U.S. banking institutions is virtually unparalleled in the corporate experience. In fact, the breadth and depth of the regulatory monitoring function is matched only by the breadth and depth of the regulatory expectations for the board monitoring function at large U.S. banking institutions themselves. While some observers raise the possibility that regulatory monitoring may reduce the incentive for board monitoring, rigorous efforts of the bank regulators in the post-crisis era have been aimed at strengthening both the regulatory monitoring function and the board monitoring function. In effect, the regulators have enlisted the boards, particularly at the largest banking institutions, in a joint effort to strengthen the oversight of these institutions. As detailed in Part I of this article, the regulatory expectations for board monitoring substantially exceeded the corporate law requirements for monitoring even before the financial crisis. The regulatory expectations and requirements for board oversight of large banking institutions in the post-crisis era are now even higher and unmatched in any other corporate sector even as governance best practices have spread to other corporate sectors. The rigorous monitoring by the bank regulators of the oversight provided by the boards of large banking institutions provides an additional measure of protection not afforded in other corporate sectors. The recurring concerns expressed by some observers about the lack of an effective corporate law mechanism for enforcing directors' oversight responsibilities are thus much diminished for banking institutions. The rigorous monitoring by the regulators of the monitoring done by a board of a large banking institution provides a significant measure of discipline and account-

[226] 2016 Clearing House Report, *supra* note 168, at 26.

ability not found in other corporate sectors.

The issue for boards of banking institutions in the "new era of bank supervision" is not commitment, but capacity, particularly, the capacity of a board of a large banking institution to superintend the wide range of increasingly complex issues that affect the operations of the institution. Some part of the capacity issue lies in the large inventory of specific oversight responsibilities that regulations and supervisory guidance impose on boards. While there is obvious rhetorical appeal in citing a regulation that requires a bank board to schedule the banking hours for the institution (the removal of which requirement would not in any real sense lighten the load on a bank board), there is in fact a cumulative burden and distraction that results from the diversion of time and attention to a host of mandated but routine matters. This diversion of time and attention should be alleviated by an appropriate pruning of the inventory of regulations and guidance documents that mandate specific board review and approval of routine matters.

The larger part of the capacity issue lies in the complexity of large financial institutions and the complexity of the markets that surround them. A large financial institution must hope to build a strong enough fortress, because it is unlikely to be able to dig a wide enough moat to protect itself from all future contingencies. Building a strong enough fortress will be largely dependent on both quantitative measures of capital and liquidity and qualitative risk management skills and processes. As the 2008 Senior Supervisors report indicated, there were significant differences in the strengths of the risk management processes among large financial firms at the time of the financial crisis.[227] The firms with integrated enterprise-wide risk management processes fared significantly better during the crisis than the firms with diffuse and less robust risk management processes. It appears that the weak risk management processes in certain institutions may be traced in the first instance to senior management who prior to the crisis had shown only slight interest in or understanding of risk management processes.

The most important risk management decision that a board is called upon to make is the choice of a chief executive officer. Choosing a chief executive officer and other senior business managers with a demonstrated appreciation for robust risk management practices is the first line of defense (and in the case of the chief risk officer the second line of defense) for the directors of a banking institution as it is for the institution itself. The directors of a banking institution must be able to place their confidence in the risk assessment and risk management skills

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[227] Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence* 2-5 (2008).

of the chief executive officer, the chief risk officer, and other senior business managers. The complexity of modern banking operations (and correspondingly of modern risk assessment and management processes) dictates board reliance on professionals with the requisite skills, a reliance that corporate law fully recognizes.[228] In this sense, the prescriptiveness of the supervisory guidance relating to a risk governance framework and an independent risk management function, as reflected in the OCC heightened standards, is an aid to the board in fulfilling its oversight responsibilities. This article has offered a critique of the breadth and depth of supervisory guidance and its imposition in many cases of management-like responsibilities on boards. It is nonetheless appropriate to note as a concluding matter that, in some cases, supervisory prescription may actually have its advantages from a board's perspective.

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[228] *See, e.g.*, Del. Code Ann. tit. 8, § 141(e).