Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension

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“Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management in what were widely regarded as institutions whose specialty it was to be masters of the issue. … [T]he corporate governance aspects of risk management failed in too many instances in financial companies.” OECD, Corporate Governance and the Financial Crisis: Key Findings and Main Messages, June 2009.

I. INTRODUCTION

The 2008 financial crisis would not have been so unexpected and devastating if it could be attributed to a set of readily identifiable factors. The best journalistic accounts have focused on particular themes, leaving a wealth of insights that cannot be easily assembled into a comprehensive theory.¹ By pointing to poor risk management, the OECD identifies an obvious target.² Large financial institutions did miscalculate risk. This diagnosis may tend to put the onus of failure on the inability of financial institutions to gauge and control risks rather than on the constellation of factors – skewed incentives, regulatory capture, passive monetary policy, 


² Similarly, the President’s Working Group identified “risk management weaknesses at some large U.S. and European financial institutions” as one of five “principal underlying causes of the turmoil in financial markets.” POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS, THE PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, at 1 (March 2008).
influx of foreign savings, risk-laden consolidation, misuse of complex financial products, faulty mathematical models, an unregulated shadow banking system, deception, and irrational optimism – that created unprecedented and unmanageable risk. Nevertheless, some U.S. and foreign banks succeeded in steering wide of the risky investments that caused the meltdown.³ In exploring ways to prevent future crises, some close attention to risk management practices is clearly in order.

Risk management in financial institutions is necessarily linked to corporate governance, which conditioned past failures and may fortify defenses against future crises. In the United Kingdom, the Prime Minister commissioned David Walker, a former head of Morgan Stanley International, to conduct an inquiry of corporate governance “in light of the experience of critical loss and failure throughout the banking system” in the 2008 financial crisis.⁴ There has been no comparable inquiry on this side of the Atlantic, but a number of the largest bank holding companies have significantly revised their corporate governance practices, particularly by enhancing board oversight of risk management and strengthening the internal leadership of the board.⁵

In this article, I examine publicly disclosed corporate governance practices of 25 of the largest bank holding companies, focusing on the control centers relevant to risk management.⁶ I find that risk management was

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³ Among U.S. Banks, JP Morgan Chase and PNC Financial Services Group, Inc. fared well; Canadian Banks also remained profitable, though they have certain vulnerable features. See Tett, supra note 1, at 149, 203, 247; Peter Boone & Simon Johnson, Canadian Banking Is Not the Answer, economix.blogs.nytimes.com (March 25, 2010).
⁴ DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES, FINAL RECOMMENDATIONS, November 26, 2009.
⁵ See infra part II and IVB.
⁶ In the past decade, the Securities and Exchange regulations and New York Stock Exchange rules have mandated extensive disclosures of corporate governance practices. See Regulation S-K, Item 407, 17 C.F.R. § 229.407, 71
indeed weakened by residual conflicts of interest and insider loyalties that deprived control centers of adequate power and independence. The recent changes in corporate governance practices adopted by many banks reflect an awareness of these problems. I argue that more comprehensive corporate governance reform in large financial institutions can strengthen their institutional competence in risk management and should be included in the range of issues to be addressed in designing a more robust financial system.

The 25 banks in my sample represent the largest bank holding companies, excluding eleven foreign owned banks, one privately owned bank, and a corporation that is better viewed as an insurance company. The sample embraces institutions of widely varying size. The four largest banks control almost 40 percent of all bank deposits, 50 percent of mortgages, and two thirds of credit cards. The assets of these four banks represent an astonishing 52 percent of gross domestic product. The two largest banks, Bank of America and JP Morgan Chase, both have assets of exceeding 2 trillion. In contrast, the four smallest banks in our sample have average assets of 46 billion. Somewhat surprisingly, the patterns of corporate governance are quite consistent throughout the sample, suggesting that any inferences from our study can be applied more broadly to a larger sphere of regional banks.


7 See Appendix A. The sample is taken from NATIONAL INFORMATION CENTER, FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, TOP 50 BANK HOLDING COMPANIES, available at www.ffiec.gov/nicpubweb/nichome, a listing as of December 31, 2009. The privately owned bank is GMAC, Inc. Metlife, Inc., technically qualifies as a financial holding company but is better treated as an insurance company.


9 Johnson & Kwak, supra note 1, at 217.

10 See NATIONAL INFORMATION CENTER, supra note 7.

11 Ibid.
As the recent crisis again revealed, the regulation of banking is dictated by the volatility and systemic risks inherent financial markets and the pervasive importance of these markets to all sectors of society. Banks are far more highly leveraged than non-financial firms -- a very well capitalized bank may have a debt-equity ratio of 12:1-- and they conduct a high volume, low margin business.\textsuperscript{12} They are uniquely susceptible to liquidity risk since they are “involved in borrowing short and lending long.”\textsuperscript{13} Bank assets invested in loans to commercial and residential borrowers have a longer term and are less liquid than bank liabilities, which are composed of checking and savings deposits available on demand and instruments, such as federal funds and certificates of deposit, with short-term maturities.\textsuperscript{14} The liquidity risk, combined with leverage and low margins, makes banks vulnerable to panics, which can run throughout society as the troubles of one bank undermines the liquidity and reputation of others.

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; a failure of the banking industry cannot be cordoned off to isolate its effects. This public interest has given rise to an express or implicit government guarantee of the banking industry’s viability. The federal deposit insurance program, which has successfully discouraged runs on the bank, represents a major government commitment to the stability of the banking system. Similarly, Western democracies, including Japan, Sweden, Israel, the Netherlands and France, have all been politically obliged to intervene to

\textsuperscript{12} See Federal Reserve Bank of Atlanta, Director’s Primer 2 (3d ed. 2002) (assumes 8 percent capitalization for typical bank); Jonathan R. Macey, Commercial Banking and Democracy: The Illusive Quest for Deregulation, 23 Yale J. Reg. 1, 4-5 (2006); Organization of Economic Cooperation and Development, Corporate Governance and the Financial Crisis: Key Findings and Main Messages, at 9, 12-13 (June, 2009).

\textsuperscript{13} Organization of Economic Cooperation and Development, supra note 12, at 9.

\textsuperscript{14} Id. at 66-10.
prevent the collapse of their banking systems. The United States government fell within a common pattern of political behavior by engaging in the S & L bailout in the 1980s and investing public funds to rescue major banks and other financial institutions in 2008.\textsuperscript{15}

Banking regulation in the United States has a long history that may be traced to the establishment of the national bank system in 1864 under the supervision of the Comptroller of the Currency (OCC).\textsuperscript{16} Over the next 150 years, the system fragmented into four federal agencies and fifty state regulators.\textsuperscript{17} The 2010 financial reform bill (hereafter the Dodd-Frank Act) provided some needed simplification by eliminating one federal agency, the Office of Thrift Supervision, and transferring most of its functions to the OCC.\textsuperscript{18} Following this modest reform, the Federal Reserve System retains jurisdiction over bank holding companies and federal regulation of their banking subsidiaries is divided between two other regulatory agencies. The Federal Deposit Insurance Corporation (FDIC) is the primary federal regulator of state-chartered banks operating as subsidiaries of some large bank holding companies. The OCC has more extensive jurisdiction as regulator of national banks, which now account for approximately 60 percent of all banking

\textsuperscript{15} See Macey, \textit{supra} note 12, at 8.
\textsuperscript{18} Dodd-Frank Wall Street Reform and Consumer Protection Act, § 312, H.R. 4173 [verify and complete citation when final version of bill is printed]
assets.\textsuperscript{19} National banks predominate among the subsidiaries of seven of the ten largest bank holding companies in our sample.\textsuperscript{20}

Banking laws and regulations have frequently extended into the domain of corporate governance. The National Banking Act of 1864 contained provisions relating to the qualifications of directors, annual elections and the minimum size of the board,\textsuperscript{21} which have been revised and supplemented in later legislation.\textsuperscript{22} Today there is a complex of laws and regulations affecting bank directors without any counterpart in general corporate law.\textsuperscript{23} Though the Banking Act of 1933\textsuperscript{24} is remembered for establishing the system of deposit insurance and for separating commercial banking and investment banking, it also required directors of national banks to be elected by cumulative voting and contained several provisions intended to enhance the accountability of directors of banks throughout the federal reserve system.\textsuperscript{25}

For example, it limited the number of directors to not more than 25, an

\textsuperscript{21} National Bank Act, supra note 16, at § 5 (minimum of 5 directors), § 9 (citizenship, residence, stock ownership, director as president), § 10 (vacancies)), 13 Stat. 99, 100-102 (1866).
\textsuperscript{25} Banking Act of 1933, supra note 24, at § 9 (cumulative voting), § 12-13 (executive officers prohibited from receiving loans from bank), § 30 (Federal Reserve System given power to remove directors), § 31 (limited number of directors and minimum stock ownership required), 48 Stat. 182-83, 186, 193-94 (1934).
important reform at the time since large city banks commonly had more than 50 directors – a practice that shielded both the directors and the banks from accountability.\textsuperscript{26} For the purpose of this article, however, the most notable regulatory legislation affecting corporate governance, is found in the Federal Deposit Insurance Corporation Improvement Act of 1991, which required federal banking agencies to establish standards for safety and soundness of all insured depository institutions.\textsuperscript{27} In 1995 the four federal regulatory agencies promulgated a common rule, the Interagency Guidelines Establishing Standards for Safety and Soundness, which is set forth in four separate sections of the Code of Federal Regulation. \textsuperscript{28} The regulation addresses the function and organization of the audit committee, internal audit, risk assessment, asset quality, interest rate exposure, and excessive executive compensation.

In view of the intensity of bank regulation, it is not surprising that securities regulation – a field that impinges on corporate governance – similarly accords banks a special status. The Securities Act of 1933 exempts offerings of securities by a national bank or other bank “supervised by the State.”\textsuperscript{29} The Securities Exchange Act of 1934, as amended in 1964, applies to bank securities but its enforcement is entrusted to federal agencies regulating

\textsuperscript{26} Note, The Glass-Steagall Banking Act of 1933, 47 Harv. L. Rev. 325, 328 n.18 (1933).
banks. The Sarbanes-Oxley Act, an amendment to the 1934 Exchange Act, includes provisions affecting corporate governance that also went into effect only with issuance of regulations by banking regulators.

There is thus ample precedent and justification to tailor corporate governance rules to the peculiar requirements of the banking industry. As Prof. Chaffins observes, financial institutions are “a breed apart” for purposes of corporate governance. This article will address matters calling for review of existing banking laws and regulations, which may not have any application to non-financial firms. The first two sections will discuss oversight of risk management and audit functions in banking, including the much neglected subject of internal auditing. They will review improved practices in many banks and discuss the possible value of new safety and soundness regulations to consolidate and expand these improvements. The third section will discuss the potential role of the board in risk management, particularly with respect to skewed incentives of executive compensation. The key factor, it will argue, relates to internal leadership of the board. The last section will consider the problematic value of a shareholder role in risk management in

32 Brian R. Cheffins, Did Corporate Governance ‘Fail’ During the 2008 Stock Market Meltdown?, 65 BUS. LAW. 1, 52 (2009). See also Jonathan R. Macey & Maureen O’Hara, The Corporate Governance of Banks, FRBNY EC. POL. REV. 91 (Apr. 2003) (argues that the fiduciary duty owed by directors should be expanded to include creditors in the case of banks); Renee Adams & Hamid Mehran, Is Corporate Governance Different for Bank Holding Companies?, FRBNY EC. POL. REV. 123 (Apr. 2003) (finds “systematic differences” between governance of banks and manufacturing firms).
light of the SEC’s proposed regulation to facilitate shareholder access to the management proxy.

II. RISK MANAGERS AND THE BOARD

The history of the 2008 financial crisis raises questions not only of the methodologies of risk managers but of their role in the corporate organization. The chief risk manager of Fannie Mae reportedly protested against a board decision to expand purchases of subprime loans. In contrast, while Washington Mutual was riding the housing bubble, the chief risk oversight officer circulated a memo stating that her department would play a “customer service” role that would not “burden” loan officers. In the case of Fannie Mae, the risk officer lacked influence; at Washington Mutual, the officer lacked independence. While corporate governance cannot improve the intellectual quality of risk management, it can address the issues of status and independence of the risk managers. As a group, the 25 banks in our sample have in fact been quite active in reassessing the risk management function in corporate organization. A new consensus on best practices is beginning to emerge.

The evolving practices on risk management have already gone well beyond the requirements of the NYSE Listed Company Manual and the Interagency Guidelines Establishing Standards for Safety and Soundness jointly promulgated by the banking regulatory agencies. The NYSE Manual

34 See Roger Lowenstein, The End of Wall Street 78 (2010).
35 Id. at 33. Similarly, the senior risk officer at Citibank entrusted with monitoring the bond trading business was a former colleague of the executive overseeing the bank’s portfolio of mortgage-backed securities and often gave him a ride home from work. As events would prove, he never asked the right questions about these risky investments. See Eric Dash & Julie Creswell, Citigroup Saw No Red Flags Even as It Made Bolder Bets, N.Y. Times, Nov. 22, 2008.
requires the audit committee to “[d]iscuss policies with respect to risk assessment and risk management.”36 The commentary adds:

While it is the job of the CEO and senior management to assess and manage the listed company’s exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company’s major financial risk exposure and the steps management has taken to monitor and control such exposure. The audit committee is not required to be the sole body responsible for risk assessment and management.37

The commentary continues by acknowledging that “[m]any companies, particularly financial companies,” manage risk through other “mechanisms,” but it makes no mention of the board of directors. The Interagency Guidelines provide no more specificity; part II requires only that banks must have “internal controls and information systems” that, among other things, provide for “effective risk assessment” and identify credit risk and interest rate risk.38

From the perspective of corporate governance, these provisions are deficient in three respects: (1) they fail to identify risk management as a core responsibility of the entire board; (2) they do not clearly indicate whether risk management is an aspect of auditing or a separate function; (3) and they fail to insist on safeguards for the independence of the risk managers.

The responsibility of the board of directors for risk management is affirmed in the manuals and circulars of all the principal bank regulatory agencies.39 A Federal Reserve circular states:

37 Ibid.
38 Inter Agency Guidelines Establishing Standards for Safety and Soundness, supra note 28, at pt. II.A, D. & E.
Boards of directors have ultimate responsibility for the level of risk taken by their institutions. Accordingly, they should approve the overall business strategies and significant policies of their organizations, including those related to managing and taking risks ... all boards of directors are responsible for understanding the nature of the risks significant to their organizations and for ensuring that management is taking the steps necessary to identify, measure, monitor, and control these risks.\textsuperscript{40}

The OCC advises that, to manage risk effectively, the board must establish “the organization’s risk tolerance” and guide the “strategic direction for managing risks.”\textsuperscript{41} To the same effect, the FDIC counsels that directors “must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and established.”\textsuperscript{42} This essential role of the board in overseeing risk is reflected also in the international standards of the Basel Committee for Bank Supervision,\textsuperscript{43} the Financial Stability Board\textsuperscript{44} and the Financial Reporting Council of the United Kingdom.\textsuperscript{45}

As a practical matter, the daunting task of establishing firm-wide risk management systems in large diversified financial institutions calls for


\textsuperscript{41} Office of the Comptroller of the Currency, The Director’s Book, The Role of a National Bank Director 10 (March 1997).

\textsuperscript{42} See Federal Deposit Insurance Corporation, supra note 23, at 17 (2005).


\textsuperscript{44} The Financial Stability Board, an organization coordinating national financial authorities, which is hosted by the Bank for International Settlements and located in Basel Switzerland, has adopted the OECD Principles of Governance as one of 12 “Key Standards for Sound Financial Systems.” With respect to board responsibilities, see Organization of Economic Cooperation and Development, OECD Principles of Corporate Governance 24 (2004).

concerted effort at the highest levels of governance. The unanticipated losses experienced in the 2008 crisis reflected a failure to account for different kinds of risk exposure distributed across geographical locations, products, divisions and legal entities. From its position at the apex of the corporation, the board is in a position to help consolidate the “various risk management strands” and to promote a stronger risk management culture throughout the organization.

It may seem uncontroversial and obvious to insist that bank boards should treat risk management as a core responsibility. Quite apart from regulatory policy, this duty could be implied from generally accepted corporate governance principles. But a 2007 study of U.S. corporations found that two thirds delegated risk oversight to the auditing committee, and among bank holding companies the practice of creating a board committee to oversee risk has only recently gained general acceptance. Among the 25 banks in our survey, 19 had a separate board risk committee

47 Avital Louria Hahn, Missing Pieces, CFO MAG., March 1, 2008.
50 See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE, at § 3.02(a)(3) (1994) (states that directors must “review and, where appropriate, approve, the corporation’s financial objectives and major corporate plans and actions.”) The assessment and management of risk is a core function of banking business of providing a payments mechanism for society. See Stiglitz, supra note 1, at 5.
51 See ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT, supra note 12, at 39.
but six of this number had established the committee since the onset of the financial crisis in 2008.52

The rationale for creating a risk committee separate from the audit committee is that risk management has a prospective as well as a retrospective dimension. The audit committee plays a vital and essential role in risk management, but its primary focus is necessarily retrospective. In approving strategy and business plans, the board must also consider risk issues with an essentially prospective focus, such as risk appetite and tolerance, techniques of risk measurement, emerging risks, direction of risk exposure, and the risk exposure of alternative planning scenarios. The Walker report to the British parliament explains,

In practice, the audit committee has clear responsibility for oversight and reporting to the board on the financial accounts and adoption of appropriate accounting policies, internal control, compliance and other related matters. This vital responsibility is essentially, though not exclusively, backward-looking. ... [T]he board [also] has responsibilities for the determination of risk tolerance and risk appetite through the cycle and in the context of future strategy and, of critical importance, the oversight of risk in real-time in the sense of approving and monitoring appropriate limits on exposures and concentrations. This is largely a forward-looking focus.53

The charters of risk committees generally describe a sphere of responsibilities quite outside the normal activities of an audit committee.54 The charter of PNC Financial Services Group, Inc., for example, states:

The Committee’s purpose is to provide oversight of the corporation’s enterprise-wide risk structure and the processes established to identify, measure, monitor, and manage the Corporation’s credit risk, market risk (including liquidity risk), and operating risk (including technology, operational, compliance, and fiduciary risk). The Committee shall periodically review management’s strategies and policies for managing these risks.”

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52 Appendix A, risk committee charters.
53 Walker, supra note 4, at ¶6.8 and 6.9.
54 Appendix A, risk committee charters.
These responsibilities are likely to be neglected if an overburdened audit committee is expected to take them on. The audit committee must deal with a daunting flow of data, quarterly deadlines in financial reporting, and heavy responsibilities in overseeing internal controls.\textsuperscript{55} It may be better able to carry out these functions if it is relieved of a responsibility over risk methodology and strategic planning that can be better handled elsewhere.

The ideas of board responsibility for risk oversight and separate risk committees have encountered increasing acceptance as corporate governance practices, but the issue of assuring the independence of the risk management function is more problematic. As a matter of principle, it is incontrovertible that risk monitoring and control should be independent of the activities generating risk.\textsuperscript{56} An OCC Manual observes that sound risk-management systems … have several things in common: for example they are independent of risk-taking activities."\textsuperscript{57} But how is this independence to be safeguarded? The Walker report argues that it requires that the chief risk officer be ultimately accountable to the risk committee:

Alongside an internal reporting line to the CEO or the CFO, the CRO (chief risk officer) should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO would require the prior agreement of the board.\textsuperscript{58}

\textsuperscript{55} See Walker, \textit{supra} note 4, at ¶6.11; Organization Economic Cooperation and Development, \textit{supra} note 12, at 39.


\textsuperscript{58} Walker, \textit{supra} note 4, at ¶ 6.21-6.25.
On this side of the Atlantic, one does indeed find some incremental movement toward safeguarding the independence of risk management by placing it under the protection and supervision of the board. Risk committee charters generally recognize the responsibility of a chief risk officer to coordinate enterprise-wide risk management activity and authorize the risk committee to conduct direct discussions with him.59 Three charters established after the 2008 financial crisis take the additional step of recommended by the Walker report. The Morgan Stanley charter directs the risk committee to:

Approve the appointment and, when and if appropriate, replacement of the Chief Risk Officer, who shall report directly to the Committee as well as to the Chief Executive Officer. Review and evaluate annually the qualifications and performance of the Chief Risk Officer.

The charters of Citigroup and Northern Trust Corporation appear to achieve much the same result by providing for separate meetings with the chief risk officer and evaluation of the scope and effectiveness of his work.

Interestingly, two large banks, continuing an older practice, put the chief risk officer on a parity with the director of internal auditing. Large bank holding companies uniformly condition the appointment and tenure of the director of internal auditing on the approval of the auditing committee.60 The audit committee charters of U.S. Bancorp and Keycorp, which continue to place risk management under audit committee supervision, require the audit committee to approve the appointment of the chief internal auditor and the chief risk officer, appropriately extending to each an equivalent safeguard of independence from management pressure.

Nevertheless, the practice of requiring the risk manager to report to the same executive who determines his pay and bonuses still persists in several

59 See Appendix A, risk committee charters.
60 In our sample, 23 banks require audit committee approval of the appointment and tenure of the chief internal auditor; one contemplates audit committee recommendations; and one is silent on the issue. See Appendix A, audit committee charters.
major banks, and according to a 2007 study of the Conference Board, only 16 percent of the directors of financial companies mention the chief risk officer as a source of information on risk issues. The statistic dramatically suggests the dominance of the CEO and CFO as a source of information to the board. Corporate governance structures may take various forms to provide the board with additional channels of communication on risk management. Some banks, for example, maintain top-level executive committees below the board to assure coordination of risk management. But in any organizational configuration, the risk committee should be empowered to assure the independence of the head of the risk management department.

The public interest in responsible risk management in financial institutions justifies a degree of prescriptive guidance beyond what would be appropriate for non-financial companies. The Interagency Guidelines Establishing Standards for Safety and Soundness represent an appropriate vehicle; they may be expanded to assign risk management as a core board concern, identify the need for separate risk and auditing committees, and require accountability of the chief risk officer to the board. As so revised, the Guidelines would consolidate and extend the actual trend of corporate governance practices in financial institutions. These modest reforms, however, will have little importance in a rubber stamp board; they will have meaning only to the extent that board has an independent capacity to provide guidance on risk management policy.

III. AUDITING


See ORGANIZATION ECONOMIC COOPERATION AND DEVELOPMENT, supra note 12, at 39.

Several risk committee charters allude to such committees. See Appendix A, risk committee charters of Bank of America, PNC Financial Services Group, Suntrust Bank Inc., Regions Financial Group, Huntington Bancshares.

The outside auditor’s role in corporate governance has received deserved attention in financial regulation and figured prominently in the Sarbanes-Oxley legislation, but since the auditor is responsible for financial reporting, its role has a somewhat oblique bearing on risk management. Even the auditor’s obligation under the Sarbanes-Oxley Act to assess the internal controls of public companies extends to the subset of internal controls relating to accuracy in financial reporting. Still, the applicable accounting standards demand some consideration of the broader issues of risk management by requiring the auditor to conduct its audit of internal controls in light of the risk of material misstatements. The external auditor may have vital feedback to offer. Thus, in the fall of 2007, AIG’s outside auditor, PricewaterhouseCoopers, informed the company that it might have a “material weakness” in risk control processes affecting swaps.

In theory, the interests of the outside auditor should be aligned with those of the audit committee; both exist to assure accuracy in financial reporting. Some of the most constructive provisions of the Sarbanes-Oxley Act serve to undergird this mutually reinforcing alignment—the requirements that the audit committee be solely responsible for hiring and supervision of the outside auditor and that it be composed of independent directors.

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68 See Public Company Accounting Oversight Board, Auditing Standard 5, at ¶ 10-12.
69 See Lowenstein, supra note 34, at 113.
but the effectiveness of this scheme depends on the active independence and engagement of the board; an audit committee drawn from a passive board may still tend to act as an arm of management, giving rise to insidious conflicts of interest. The effectiveness of the outside auditor as a troubleshooter in risk management is thus linked to the issues of board oversight to be discussed later in this article.

The less heralded function of internal audit has a more direct bearing on risk management. Apart from other duties, such as assuring compliance with company policies and assisting in periodic review of business plans, the generally accepted scope of internal auditing requires the testing of internal controls, including not only those controls relating to financial reporting but those pertaining to legal compliance and the general effectiveness of the organization. In this respect, the work of internal audit overlaps

70 SOX, supra note 67, §§ 202, 301 & 407, 116 Stat. 745, 772, 775, 790 (codified at scattered sections of 15 U.S.C.). Section 301 established standards of independence on audit committees requiring changes in SEC regulations and Exchange rules. The Exchanges, however, went well beyond compliance with the Act and issued more extensive regulation of directorial independence on the board itself. Section 407 requires disclosure of whether the audit committee includes a financial expert. Like many other public companies, bank holding companies in our sample have sought shareholder favor by identifying two or more members of the audit committee as financial experts in their proxy statements. On definition of financial expert, see 17 C.F.R. § 229.407(d)(5) (2010).


72 See infra pt. IV.

73 The generally accepted framework for internal auditing is set forth in COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO), INTERNAL CONTROL-INTEGRATED FRAMEWORK (1992). See ORGANIZATION ECONOMIC COOPERATION AND DEVELOPMENT, supra note 12, at 35-37; Institute of
significantly with risk management. Risk managers must necessarily rely on internal auditors to review the “effectiveness of risk management procedures and risk assessment methodologies.”

One of the board’s primary responsibilities in risk management, as outlined in the Federal Reserve’s Bank Holding Company Supervision Manual, is “ensuring that the company has an effective and independent internal audit function.” Accordingly, it is the general practice among bank holding companies to put the internal audit function under the supervision of the audit committee. In exercising this oversight, the board is in a position to use the work of internal auditors to secure “an independent check and assurance on the information received from management on the operations and performance of the bank.” Internal audit potentially gives the board a separate channel of information that it can direct to areas of concern.

In the large diversified financial service companies that emerged in the late 1990s, it is a formidable challenge to conduct the internal auditing necessary to identify, monitor, and control risk-generating activities. The

Internal Auditors, 28 Putting COSO’s Theory into Practice, TONE AT THE TOP, at 1 (2005). COSO is a private organization of five leading professional organizations, including the Institute of Internal Auditors. It defines internal audit as a process designed to provide reasonable assurance regarding achievement of objectives in three areas: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. See http://www.coso.org.

74 BASEL COMMITTEE ON BANKING SUPERVISION, INTERNAL AUDIT IN BANKS AND THE SUPERVISOR’S RELATIONSHIP WITH AUDITORS 3 (Aug. 2001). See also Federal Reserve System, Division of Banking Supervision and Regulation, Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies, SR 95-5, at 10 (Nov. 19, 1995) (controls should be tested by internal audit); Federal Deposit Insurance Corporation, supra note 23, at 23 (internal audit function an important element of internal control system).

75 Federal Reserve System (Manual), supra note 40, at § 1050.1.3.1.1.

76 See Appendix A, audit committee charters.

77 BASEL COMMITTEE ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANIZATIONS, at 15 (Feb. 2006).
Bank Holding Company Supervision Manual observes that "[a]s the complexity of financial products and supporting technology has grown, in combination with greater reliance on third-party service providers, the importance of internal audit’s role in identifying risks and testing internal controls has increased." The dispersion of operations among geographical locations and distinct legal entities can pose additional obstacles to risk detection. The National Information Center of the Federal Financial Institution Examination Council posts organizational hierarchy reports that, together with selective web searches, can yield some insight into this dimension of complexity. Wells Fargo, for example, lists more than 400 separately incorporated loan originators scattered throughout the United States, including mortgage companies and finance companies occupying various business niches. Many of these loan originators were recently acquired and continue to do business under their own name as affiliated Wells Fargo companies. The sprawling array of satellite companies also includes insurance agencies, securities brokerage firms, leasing companies, asset management companies, international nonbank subsidiaries, specialized international banking agencies, and numerous offshore entities, mostly incorporated in the Cayman Islands.

Effective internal auditing offers the only hope of enforcing effective risk management policies in such a complex institutional settings. The strength of the internal audit is a function not of only adequate resources and the technical competence but the operational independence of the auditors. The guidelines of the Basel Committee on Banking Supervision, the principal

78 Federal Reserve System (Manual), supra note 40, at §§ 1050.1.3.1.1 and 1050.2.3.1 (July 2009).
79 See www.ffiec.gov/nicpubweb (organizational hierarchy report as of February 2010).
80 While it yields certain insights, the report has limitations as a data base. It lists the names of companies without indicating their current status and contains an uncertain number of double entries.
agency establishing international banking standards, repeatedly stress this point. Thus, a 2001 document articulating standards for internal auditing includes as one of its cardinal principles:

The bank’s internal audit function must be independent of the activities audited and must also be independent from the every day internal control process. This means that internal audit is given an appropriate standing within the bank and carry out its assignments with objectivity and impartiality.\(^{81}\)

The guidance on internal control systems, issued by a subcommittee chaired by high-level officials of the Federal Reserve system, underlines that “[i]t is critical that the internal audit function is independent from the day-to-day functioning of the bank and that it has access to all activities conducted by the banking organization.”\(^{82}\) This essential condition of operational independence leads to issues of corporate governance.

The operational independence of the internal auditing function depends most importantly on its relation to the audit committee, which is charged with a similar responsibility of overseeing the achievement of management objectives. The charters of audit committees reveal both strengths and weaknesses in this area. On the positive side, all the bank holding companies in our sample require that the audit committee “approve” or “review” the appointment and tenure of the manager of internal audit, and most committee charters use the stronger term “approve.” About half of the charters state that the audit committee is to approve or review annual auditing plans. This authority, if diligently exercised, may indeed give the audit committee a wide grant of power to assure the necessary operational independence of internal auditing. In addition, audit committee charters generally expect the committee to “approve,” “review” or “discuss” the

\(^{81}\) Basel Committee on Banking Supervision, supra note 74, at 4.

budgets of the internal audit department; some charters also call for review of staffing or compensation.

Nevertheless, the audit committee charters reveal significant deviations from standards advocated by the principal regulatory agencies in the areas of reporting and administrative oversight. The Federal Reserve Bank Holding company Supervision Manual affirms that “[t]he ideal organizational arrangement is for this [internal audit] manager to report directly and solely to the audit committee regarding both audit issues and administrative matters…”\(^{83}\) The Manual recognizes that many institutions place the manager of internal audit under a “dual reporting arrangement: functionally accountable to the audit committee on issues discover in the internal audit function, while reporting to another senior manager on administrative matters.” But it notes this practice of dual reporting creates “potential for diminished objectivity” with respect “audits concerning the executive to whom he or she reports” and recommends that, if an institution adopts a dual reporting arrangement, it should specify that the internal audit manager reports “administratively to the CEO.”\(^{84}\)

The manuals of the FDIC, OCC and FFIEC mirror almost word for word the language of the Federal Reserve Manual. While advocating that the internal audit manager report “solely and directly” to the audit committee, they still countenance a dual reporting arrangement with proper safeguards.\(^{85}\) The OCC manual points, however, to the pitfalls of requiring the manager to report to a senior executive on administrative matters:

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\(^{83}\) Federal Reserve System (Manual), \textit{supra} note 40, at § 2060.05.1.1.1
\(^{84}\) Ibid.
Such an arrangement potentially limits the internal audit manager’s independence and objectivity when auditing the senior executive’s line of business. Thus, chief financial officer, controller, or other similar positions should generally be excluded from overseeing the internal audit activities.86

Each of the manuals call attention to the importance of shielding the internal audit department from executive interference on such administrative matters as “resources, budget, appraisals and compensation,” but the IT examination manual of the Federal Financial Institution Examination Council goes into further detail; it states that “[a]dministrative matters in this context include routine personnel matters such as leave and attendance reporting, expense account management, and other departmental matters such as furniture, equipment and supplies.”87 A moment’s reflection will reveal that this level of detail is by no means trivial. The internal auditor must constantly demand access to the work product of other employees — a process that involves inconvenience or, worse, discomfort. The discovery of discrepancies in an audit may leave trail of antagonism and lasting grievances. The auditor must be protected from the risk of future noncooperation or harassment and assured that his or her interests in career advancement is served by a punctilious performance of the job. The necessary protection can only be found in audit committee supervision.

Among the audit committee charters in our sample, only two define the audit committee’s oversight of administrative matters in a broad manner that appears to comport with the FFIEC guidance.88 Seven are silent on the matter; the remainder allude to audit committee approval or advice on budgets, staffing, or, in one instance, compensation but do not appear to authorize the committee to involve itself in detailed administrative matters

87 Federal Financial Institutions Examination Council, supra note 85, at 8.
88 See Appendix A, audit committee charters (Citigroup, Inc. and Bank of New York Mellon Corporation).
affecting the internal audit. Somewhat more than half of the charters are unclear on the reporting obligations of the internal audit manager, but four implicitly suggest the absence of direct reporting to the audit committee by alluding to the internal auditors’ reports to management.\textsuperscript{89} Five continue the criticized practice of requiring functional reporting to the audit committee on audit issues and administrative reporting to a senior executive.\textsuperscript{90} None require administrative reporting to the CEO as recommended by the regulatory agencies. Only two state in general terms that the internal audit manager should report to the audit committee, thereby complying with the regulators’ recommendations.\textsuperscript{91}

The vital role of the internal audit in risk management calls for clear and consistent safeguards assuring its operational independence in financial institutions. This survey of audit committee charters suffices to establish the need to better define the internal auditors’ reporting obligations to the audit committee and the audit committee’s oversight of the administrative side of the internal audit. It is not the place here to make specific proposals; the formulation of appropriate safeguards of audit independence would call for more detailed survey of industry practices and consultation with professional associations.\textsuperscript{92} But the Interagency Guidelines Establishing Standards of

\begin{itemize}
\item \textsuperscript{89} See Appendix A, audit committee charters (PNC financial Services Group, Suntrust Banks, Inc., Regions Financial Corporation, and Discover Financial Services).
\item \textsuperscript{90} See Appendix A, audit committee charters, (Capital One Financial Corporation, BB&T Corporation, American Express Company, Keycorp and CIT Group, Inc.).
\item \textsuperscript{91} See Appendix A, audit committee charters (Citigroup, Inc. and Popular, Inc.).
\item \textsuperscript{92} For example, the formulation of industry standards would need to review the place of the compliance function of internal auditing, i.e. compliance with laws and regulations. The compliance function is included in scope of internal audit under the COSO definition (see supra note 73), but there is some diversity in actual practice. A few bank holding companies in our sample give the risk committee responsibility for overseeing the compliance function.
\end{itemize}
Safety and Soundness again appear to be the appropriate vehicle to formulate industry standards.\textsuperscript{93}

\textbf{IV. THE BOARD AS CONTROL CENTER}

In a recent study of corporate governance in banking, a panel of the Basel Committee on Banking Supervision reiterated the conventional view that the board of directors is an essential element of “checks and balances” in the “organizational structure of any bank.”\textsuperscript{94} The panel listed oversight by the board of directors as one of the four important forms of oversight, together with “direct line supervision,” the role of professionals detached from the day-to-day operations, and “independent risk management, compliance and audit functions.” A similar assumption underlay the exchange rules requiring predominantly independent boards issued in 2003.\textsuperscript{95} Yet there is little evidence that the directors of major banks acted to mitigate the excessive risks leading to the 2008 financial crisis or even that they assumed responsibility for bank losses. Robert Rubin, a director and head of the Citigroup executive committee, rejected criticism of his role in the bank by saying he was not involved in the “management of personnel or operations,” implicitly also exculpating other less influential directors from any responsibility for the crisis.\textsuperscript{96}

Can the board of directors serve as a check on unsound sound risk management practices? The question acquires urgency because the independent directors on the board are the only internal control center capable of regulating executive compensation, which is often blamed for

\textsuperscript{93} See \textit{supra} note 28.
\textsuperscript{94} Basel Committee on Banking Supervision, \textit{supra} note 77, at 12.
\textsuperscript{95} See \textit{infra}, note 99 and accompanying text.
creating skewed incentives for risk taking.\textsuperscript{97} Today corporate boards are composed overwhelmingly of independent directors, that is, directors meeting regulatory criteria of independence from management. Following a trend toward more independent boards in the 1990s, the Sarbanes-Oxley Act of 2002 required audit committees to be composed of independent directors;\textsuperscript{98} at the request of the SEC, the exchanges subsequently issued new standards on directorial independence, effective in November 2003,\textsuperscript{99} which required that a majority of directors on the entire board meet specified criteria of independence and that the nominating committee as well as the audit committee be composed entirely of independent directors. U.S. corporations generally embraced the new rules by going beyond the minimum requirements. A 2004 survey of The Conference Board found that 74\% of directors in companies with over $10 billion revenues qualified as independent.\textsuperscript{100} The large bank holding companies in our sample have gone even further. Recent proxy statements report 85\% of the directors as being independent.\textsuperscript{101}

**A. BOARD LEADERSHIP AND RISK MANAGEMENT**

There can be little value, however, in filling boards with nominally independent directors unless they possess leadership institutions enabling them to act independently. Two such institutions have in fact evolved – one predating the Exchange rules and the other instigated by them. During the

\textsuperscript{101} See Appendix A, 2009 proxy statements.
1990s, nominating committees became a nearly universal unit of corporate boards with increasingly broad responsibilities. Their growing importance led the SEC to require detailed disclosures in proxy statements concerning nominating committees and their activities.\footnote{102} Now usually designated the governance committee (or “nominating and governance committee”), these committees not only make nominations to fill board vacancies but characteristically also recommend the assignments of directors to particular board committees and propose the allocation of responsibilities among the committees and between the board and management.\footnote{103} The committees frequently also share responsibility for succession planning for top executive positions.\footnote{104}

The 2003 Exchange rules brought a second innovation – “regularly scheduled” executive sessions, outside management’s presence, presided over by a designated director. The NYSE rule states that these sessions are needed “[t]o empower non-management directors to serve as a more effective check on management” and if a particular director required is chosen to preside over the executive sessions, his or her name should be disclosed on the company website or proxy statement.\footnote{105} The practice of appointing a presiding director quickly spread among listed companies.\footnote{106} All but three of the bank holding companies in our sample designate a particular director,

\footnote{102} 17 C.F.R. § 229.407(c) (2010).
\footnote{103} See JAMES J. DARAZSDI & ROBERT B. STOBAUGH, NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, THE GOVERNANCE COMMITTEE (2003). The governance committee charters in our sample usually reveal that the committee recommends assignments of directors to particular committees. See Appendix A.
\footnote{104} See SPENCER STUART, SPENCER STUART BOARD INDEX, THE CHANGING PROFILE OF DIRECTORS 6 (2006).
\footnote{105} NYSE, Inc., supra note 36, at § 303A.03. For the counterpart in NASDAQ rules, see NASDAQ, INC., MANUAL, § 5605(b)(2).
\footnote{106} See SOCIETY OF CORPORATE SECRETARIES AND GOVERNANCE PROFESSIONS, INDEPENDENT BOARD LEADERSHIP: NON-EXECUTIVE CHAIRS, LEAD DIRECTORS AND PRESIDING DIRECTORS 4-8 (2007).
usually called the lead director, to preside over executive sessions.\textsuperscript{107} Though the actual importance of the position and the frequency of executive sessions varies widely, many of the large bank holding companies in our sample responded to the 2008 financial crisis by redefining and expanding the lead director’s responsibilities.

The governance committee and lead director, however, have limited bearing on the sphere of decision making that pertains to risk management. The governance committee concerns the internal organization of the board, a matter that has only tangential relationship to risk taking. The lead director’s primary role is to facilitate the board’s review of the CEO’s performance by conducting discussions in the CEO’s absence. While this process may have some bearing on executive compensation issues affecting risk management, other risk management issues arise from strategic planning and demand the \textit{presence} of the CEO as a source of information and ideas. Acting alone in executive sessions, the independent directors cannot make informed decisions on matters that require access to inside knowledge of the business plans and operations. A wide spectrum of vital risk management issues fall into this category of decision making critically depending on inside information.

The experience of the 2008 crisis demonstrates that the removal of the CEO is likely to come too late to count as a risk-management measure in the volatile business of banking. The CEOs of Citigroup and Merrill Lynch were forced out in November 2007 \textit{after} the companies had incurred huge write downs; and a similar fate awaited the CEO of AIG in mid-June 2008 when the outside auditor required the company to recognize massive losses.\textsuperscript{108} The lead director of Merrill Lynch, Alberto Cribiore, reportedly took the lead in ousting

\textsuperscript{107} See Appendix A, 2009 and 2010 proxy statements, corporate governance guidelines.
\textsuperscript{108} See ANDREW ROSS SORKIN, TOO BIG TO FAIL, THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON Fought TO SAVE THE FINANCIAL SYSTEM AND THEMSELVES 60-61, 147, 152, 160-161 (2009); Lowenstein, \textit{supra} note 34, at 110, 140.
the CEO, Stan O’Neal, in a meeting held in his absence,\(^\text{109}\) and the AIG board also met in executive session to effect a change in management,\(^\text{110}\) but these actions came too late. The institution of executive sessions and the lead director did not operate to check the chain of decisions that caused the companies to incur disastrous risks in the first place.

In one of his richly insightful articles in the Banking Law Journal, Christopher Zinski presents a case for collaboration between the CEO and the board through a dialogue between fictional characters.\(^\text{111}\) A director notes that, “in general, the board is charged with supervising management and management is charged with implementing the company’s strategy and business plan.”\(^\text{112}\) But strategic planning, he suggests, occupies a kind of middle zone calling for management and the board to act as partners. “It needs to be a collaborative effort,” he insists. A veteran CEO concurs but observes that the collaborative process still involves distinct roles for the CEO and the board. As the head of the company, the CEO ordinarily has the initiative; he or she should articulate ideas of strategic planning and submit them to criticism of the board. This means that “company strategy needs to pass a very rigorous test, the test of scrutiny by highly competent directors on my board.”\(^\text{113}\)

The possibility of the board functioning as an element of the company’s check and balances lies in this process of scrutiny of fundamental business decisions. In the case of risk management, the relevant decisions concern such matters as the policies for risk appetite and risk tolerance and the adequacy of internal controls. The board can serve as a control center, keeping the company on a balanced course, only if the scrutiny is thorough,

\(^\text{109}\) See Lowenstein, supra note 34, at 109.
\(^\text{110}\) See Sorkin, supra note 108, at 152.
\(^\text{112}\) Id. at 938
\(^\text{113}\) Id. at 939.
well informed and searching. David Walker, the former Morgan Stanley executive, analyzes the process as consisting of four steps: “presentation by the executive, a disciplined process of challenge, decision on the policy or strategy to be adopted and then full empowerment of the executive to implement.” He suggests that the “essential ‘challenge’ step” appears to have been missing in many boards before the 2008 crisis. “The most critical need,” he argues, “is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues.”

A rigorous process of scrutiny or challenge can be immensely facilitated by an impartial moderator. It is difficult, to say the least, for a CEO to advocate and defend a position while gauging the board’s response and bringing the discussion to a balanced resolution. The CEO’s sense of personal conviction, though commendable in itself, is inevitably in tension with his or her ability to act as impartial critic and referee. Where the CEO leads the discussion of his or her own proposals, the process of decision making is biased toward adoption of the proposals with minimal consideration of alternatives. The absence of independent board leadership, encouraging directors to express objections and to weigh all available options, is enough to explain the failure to many boards to act as a check on their company’s slide into financial distress. There is, however, a more fundamental problem: the board must be well enough informed to carry out a meaningful scrutiny of management strategies.

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114 See Walker, supra note 4, at 12.
115 Ibid.
116 Laboratory studies show that groups with directive leaders use less available information, suggest fewer solutions, exercise more self-censorship, and are more likely to discourage dissent. See James K. Esser, Alive and Well after 25 Years: a Review of Groupthink Research, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 116, 131-132 (1998).
As in other fundamental business decisions, the directors cannot deliberate meaningfully on risk management issues without sufficient inside knowledge of the bank’s operations and objectives. They may assiduously peruse written materials on agenda items, but, to the extent that the directors gain a grip of the issues before them, they will want to probe top executives for clarifications, confirmations, and explanations on particular points. In all but four of the banks in our sample, the CEO is only member of the board with a current executive position in the bank. While the exclusion of other executives from the board may create an appearance of independence, it is in fact a point of vulnerability. It may narrow the board’s source of inside information, and, at worst, it may place the CEO in a position to manipulate the board. There is, however, no one-size-fits-all formula. The best arrangement to assure board access to inside information will depend on the personal qualities of management and the working relationship between management and the board. Only one generalization holds: the board itself is best able to determine the persons who can assist its discussions and the documentation it needs; and to do so, it needs effective leadership -- the same kind of leadership the board requires for balanced board discussions.

B. OPTIONS FOR BOARD LEADERSHIP

These reflections suggest that board is unlikely to function as an element of checks and balances in a bank’s organizational structure unless it possesses independent leadership. Conventionally, this leadership calls for separation of the offices of CEO and chairman of the board, but it is not so

117 See Appendix A. The exceptions were JP Morgan Chase & Co.(Chairman/CEO and Executive Chairman JP. Morgan Investment Bank); Goldman Sachs Group Inc. (Chairman/CEO and President/COO), Bank of New York Mellon Corporation (Chairman/CEO & President), and KeyCorp (Chairman/CEO & Vice Chair/Chief Admin Officer).

simple. A board chairman can have limited powers, and a lead director’s responsibilities can be expanded to include shared oversight of the agenda and available information at board meetings. In either case, the leadership of the board is not the same thing as leadership of the company; it pertains only to the board’s limited functions in overseeing the CEO’s performance and collaborating with the CEO in strategic planning, including those matters pertaining to risk management.

Recent corporate governance reforms have, in some instances, responded to this need for independent board leadership. Four of the five biggest Canadian banks split the offices of CEO and chairman of the board in 2003 following the first wave of financial scandals in the new millennium; 119 three years later, Marshall and Ilsley Corporation, a large regional bank based in Milwaukee, Wisconsin, appointed an independent board chairman. 120 Following the 2008 financial crisis, both Citigroup and Bank of America engaged in a comprehensive review of their corporate governance practices and adopted an independent board chairmanship as part of a series of reforms. Significantly, in both banks, the chairman of the board also serves as chairman of the governance committee, giving him a position of leadership over all internal board affairs. 121

The option of an independent board chairman continues to be a recurring item on the corporate governance agenda of some banks. In the last two proxy seasons, shareholder groups have submitted proposals to the six largest bank holding companies (other than Citigroup) to create an

120 See Appendix. A, proxy statements 2005 to present.
121 See Appendix A, 2010 proxy statements. The governance principles of the Financial Reporting Council of the United Kingdom recognize the logic of having an independent chairman of the board chair the nominating committee. See UK Corporate Governance Code, ¶ B.2.1 (June 2010) (“The chairman or a non-executive director should chair the [nominating] committee.”) available at http://www.frc.org.uk.
independent board chairmanship. The Bank of America adopted an independent chairmanship in 2010, the year after receiving such a proposal. About one third of the banks in our sample profess in their corporate governance guidelines to have no set policy on separation of the positions of chairman and CEO but to consider the issue from time to time as circumstances merit. Only one bank states a policy favoring unification of the positions. It is, of course, a common practice for an outgoing CEO to serve as chairman of the board for a transitional term following appointment of his successor. Currently, the former CEO serves as board chairman in two major financial services companies, Morgan Stanley and State Street – perhaps for only a limited period if past practice is a guide.

The evolving role of the lead director also counts as an important response to the need for independent leadership on the board. Somewhat more than half of the banks in our sample now assign duties to the lead director that traditionally pertained to the chairman’s role. U.S. Bancorp, for example, states that “in the absence of an independent chairman,” the lead director has the responsibility to “set the Board’s agenda jointly with the chief executive officer, approve Board meeting schedules to assure there is enough time for discussion of all agenda items; [and] oversee the scope, quantity, and timing of the flow of information from management to the Board.” One does find, however, a gradation in the scope of language describing the lead

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123 See Appendix A, corporate governance guidelines.
124 BB&T Corporation, corporate governance guidelines.
125 Two banks, Wells Fargo & Company and Northern Trust Corporation, now combine the offices of chairman and CEO but recently separated them for a transitional period following, appointment of a new CEO. See Appendix A, 2009 and 2010 proxy statements.
126 See Appendix A, 2009 and 2010 proxy statements.
127 See Appendix A, proxy statements and corporate governance guidelines.
director’s responsibilities. Capital One Financial Corporation states in its corporate governance guidelines only that the lead director may “suggest matters and issues for inclusion on the Board agenda” [and] [w]ork with chairman and Committee chairs to ensure that there is sufficient time for discussion of all agenda items.”

Among the banks assigning broad responsibilities to the lead director, the director also chairs the governance committee in three companies, further enhancing his potential for leadership of the internal affairs of the board. Though the lead director may lack the authority of a board chairman, the enlargement of his sphere of leadership implicitly recognizes the need for independent board leadership and represents an important step in that direction.

C. REGULATORY ISSUES

Regulatory measures are likely to be clumsy or ineffective tools for promoting board leadership. Mandatory disclosure rules can help produce conformity to an accepted practice, such as appointment of financial experts to the audit committee, but they are likely to be worthless in promoting controversial change. Disclosure has been an utter failure in encouraging governance committees to engage in outreach to shareholders. The recently enacted provision of the Dodd-Frank Act requiring corporations to explain their reasons for combining or separating the offices of CEO and chairman may similarly turn out to add only an extra paragraph of verbiage to proxy statements. The alternative of prescriptive guidance can define and consolidate practices that are generally recognized to be desirable, but it

129 Capital One Financial Corporation, corporate governance guidelines (effective February 1, 2010), at 7.
130 See Appendix A, 2010 proxy statements (Goldman Sachs Group, Inc, Huntington Bancshares Incorporated, and Discover Financial Services).
132 See infra notes 184 & 185 and accompanying text.
133 Dodd-Frank Wall Street Reform and Consumer Protection Act, § 972 [verify and complete citation when final version of bill is printed]
is likely to result only in formalistic compliance if pushed too far. Still, there may be some practical value in building the growing acceptance of giving the lead director broader responsibilities where the positions of CEO and chairman are combined. For example, the Interagency Guidelines Establishing Standards for Safety and Soundness might confer on the lead director a right to consultation on the agenda of meetings and on information to be provided to directors.134

Other options emerge if one considers corporate governance reforms as part of a larger regulatory strategy of assuring the independence and effectiveness of control centers in the corporation. Certain portions of the Sarbanes-Oxley Act further this strategy – for example, by requiring an independent audit committee and enlarging the scope of the external audit135 - - but other provisions are based on an older, hierarchical model of the corporation, requiring harsh regulatory discipline of corporate executives.136 Such punitive controls have proven ineffective137 and unfortunately tend to justify both a hierarchical organizational structure and the prerogatives of the CEO. I have argued elsewhere that corporate governance reforms calculated to enhance the corporation’s capacity for self-regulation would permit some selective relaxation of external controls without any compromise of regulatory objectives.138 The goal of fostering more effective self-regulation,

134 See supra, note 28.
137 See, e.g., Brian I. FitzPatrick, Congressional Re-election Through Symbolic Politics: The Enhanced Banking Criminal Penalties, 32 AM. CRIM. L. REV. 1 (1994); Ian Ayres & John Braithwaite, Responsive Regulation, Transcending the Deregulation Debate (77-78) (1992) (observes that front-end improvement of the decision-making process can be more effective than back-end sanctions for harmful conduct).
138 See Michael E. Murphy, Pension Plans and the Prospects of Corporate Self-Regulation, 5 DEPAUL BUS. & COM. L. J. 503, 563-577 (2007); Michael E.
moreover, appears most compatible with the earliest republican values of our country.\textsuperscript{139}

As a case in point, one may consider the provisions of the Sarbanes-Oxley Act intended to assure the effectiveness of internal controls for financial reporting. The real substantive guarantee consists of the requirements of a management statement in the annual report assessing the effectiveness of the company’s internal controls and a report of the outside auditor separately attesting to the effectiveness of these controls.\textsuperscript{140} The Act, however, requires additional personal certifications of the chief financial officer and the chief executive officer.\textsuperscript{141} The chief financial officer’s certification becomes largely obsolete if the internal auditing function, responsible for testing internal controls, is placed securely under the audit committee’s supervision. How can the CFO attest to the effectiveness of controls, under separate administration, that exist to check on the accuracy of his department’s reporting? The chief executive officer’s certification invites formalistic compliance since the internal controls concern technical accounting details and procedures outside the ordinary scope of his or her leadership\textsuperscript{142} and it loses much of its justification with separation of the positions of CEO and board chairman. Should the board chairman also be required to offer a personal certification? If not, what is the basis for

\begin{flushleft}
Murphy, Restoring Trust in Corporate America: Toward a Republican Theory of Corporate Legitimacy, 5 NYU J. L. & BUS. 415, 476 (2009); Michael E. Murphy, Attacking the Classified Board of Directors: Shaky Foundations for Shareholder Zeal, 65 BUS. LAW. 441, 474-475 n 288, 477-478 (2010)
\textsuperscript{139} See Murphy (2009), supra note 138.
\textsuperscript{141} SOX, supra note 67, §302(a), 116 Stat. 745, 777 (codified as 15 U.S.C §7241).
\textsuperscript{142} Such formalistic compliance might include appointment of a disclosure committee, documentation of meetings and consultations, and payment of fees.
\end{flushleft}
discrimination between the two positions? These reflections suggest the possibility of a conditional waiver of the requirement that the CFO and CEO certify the adequacy of internal controls where a banking institution complies with heightened standards for the independence of the internal audit function and separates the position of CEO and chairman.\textsuperscript{143} Such a limited and conditional deregulation might be expected to encourage appointment of an independent chairman in banks that are already moving in the direction of stronger board leadership.

V. SHAREHOLDERS AS CONTROL CENTER?

The landmark banking legislation of the New Deal, the Banking Act of 1933, included a provision to make national banks more accountable to minority shareholders through cumulating voting.\textsuperscript{144} The exercise of cumulative voting was in fact gravely weakened by the absence of any means for minority shareholders to include their nominees in the management proxy;\textsuperscript{145} it was further debilitated by an OCC regulation and corporate bylaws subjecting shareholder nominees to lengthy notice requirements\textsuperscript{146} and rendered relatively unimportant by the emergence of bank holding companies unaffected by the cumulative voting rule.\textsuperscript{147} Four years ago, shortly before

\textsuperscript{143} The requirements are found in three subsections of section 302, subsections (a)(4) through (6). See SOX, supra note 67, § 302(a)(4)-(a)(6), 116 Stat. 745, 777 (codified at 15 U.S.C. § 7241(a)(4)-(a)(6)).


\textsuperscript{146} In 1986, the OCC repealed a regulation imposing discriminatory notice requirements on non-management nominations for corporate director but acknowledged that banks retained “broad authority to prescribe bylaws” regulating directorial elections. 51 Fed. Reg. 29089 (Aug. 14, 1986).

the financial crisis, the mandatory requirement of cumulative voting was finally eliminated in the ironically named Financial Services Regulatory Relief Act of 2006.\textsuperscript{148}

This year, as part of broader financial reforms, the SEC was authorized to pursue the same goal of promoting corporate responsibility through shareholder representation on the corporate board. The agency had twice issued a proposed regulations to give shareholders access to the management proxy for directorial nominations -- in 2003 following the collapse of Enron and ensuing corporate scandals and in 2009 following the 2008 financial crisis -- but it had delayed action amid doubts as to its authority to act in this area. When the Dodd-Frank bill broadly confirmed its authority, the SEC issued final regulations on August 25, 2010.

The SEC release, Facilitating Shareholder Director Nominations, identified improved risk management as one of the objectives of the new regulation. It states that the financial crisis “heightened the serious concerns of many shareholders about the accountability and responsiveness of some … boards of directors to shareholder interests” and raised questions about “whether boards need to be more accountable for their decisions regarding issues such as compensation structures and risk management.”\textsuperscript{149} My purpose here is to examine the underlying premise as it applies to banking: will shareholder access to the management proxy for director elections promote better risk management?


The case against facilitating shareholder director nominations is easiest to make and was vigorously argued by the banking industry in response to the proposed regulations in 2009. First, in a complex and opaque industry, shareholders have very limited knowledge of how to manage risk and are likely predisposed toward short-term solutions. Loan quality is difficult to observe, particularly when the loans are extended to businesses that are themselves opaque or to numerous small borrowers through numerous intermediaries. Banks can cover the consequences of bad loans, at least for a while, by extending new loans to borrowers who cannot otherwise service their debt obligations. They can also alter the risk composition of their assets with relative ease through trading activities. The dark side of bank liquidity is that it may allow banks to substitute assets and shift risks in problematic ways. Moreover, as the events of 2008 showed, banking crises occur too rapidly for an effective shareholder response. As noted earlier, the removal of CEOs of failing firms came too late to count as a risk management measure; shareholder action, which is tied to annual or special meetings, is far less likely to provide a timely remedy. In addition to being in a poor


153 As might be expected, ratings agencies disagree more often over bank bond issues than over other similar issues. See Morgan, supra note 152, at 874, 887.
position to attempt monitoring, shareholders are also commonly imbued an orientation toward short-term market valuation that conflicts with sound risk management in banking. As Wachtel, Lipton, Rosen & Katz noted in a comment to the 2009 proposal,

A major contributor to the severity of the financial crisis was excessive risk-taking and widespread over-leverage. Because leverage increases both potential equity returns and bankruptcy risk, shareholders (who can easily and inexpensively diversify their investment across many companies) tend to prefer that companies incur more leverage than do directors or management (whose positions and reputations are closely linked to the success or failure of a particular company).  

Secondly, shareholder nominations would bypass the vetting of prospective candidates by the governance committee of the board. To mitigate this problem, the new regulation requires nominating shareholders to state that, to the best of their knowledge, their “nominee meets the director qualifications, if any, set forth in the registrant’s governing documents.” But such statements are cheap; they cannot be monitored by the governance committee; and even if the shareholder-nominated director is carefully selected, the director may still not enjoy the confidence of other board members who were removed from the process of selection. This observation leads to the potential problem of fragmentation within the board.

A New York Times editorial expressed the hope that the SEC’s proposed shareholder nomination procedure “would give shareholders a chance to shake up boards that have become rubber stamps for management decisions.” But a director’s influence in the small and cohesive groups that comprise corporate boards proceeds from trust and dialogue among members.

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154 Banks have proven, however, to be effective monitors of other banks. See Craig H. Furfine, Banks as Monitors of Other Banks: Evidence from the Overnight Federal Funds Market, 74 J. OF BUS. 33 (2001).
155 Proposed Rule, comments, supra note 150, Wachtel, Lipton, Rosen & Katz, at 4-5.
156 17 C.F.R. 240.14n-101, item 5(e).
New board members join a small group with well established norms that typically place a high value on collegiality.\textsuperscript{158} The board in fact \textit{must have such norms} if it is to perform its task. If new members wish to succeed, they learn to play by the unwritten rules dictating such behavior.\textsuperscript{159}

Social psychology teaches that, in any small group, most common tactic to deal with a member who defies norms is to treat the nonconforming member as an “institutional deviant” whose ideas and values are rejected \textit{a priori}. The group unites against the institutional deviant in an effort -- often a necessary effort -- to perform its chosen function.\textsuperscript{160} A new board member who is elected by challenging management in a shareholder nominating process may take his seat with the perceived status of an unwanted director with a distinct agenda and dubious qualifications.\textsuperscript{161} Joining the board under these circumstances, the shareholder-nominated director may be outvoted, ignored, and excluded from the sources of information to be gained from informal interaction with other members and management.\textsuperscript{162}

The case for shareholder representation as a means of improving risk management, I argue, has a somewhat hypothetical character. It assumes that the problems of unqualified and unwanted directors can be averted by some process of collaboration between shareholders and corporate governance committees. If an orderly and collaborative process of selecting

\begin{enumerate}
\item \textsuperscript{159} Social psychology teaches that all human groups have norms of behavior that enable the group to achieve what it considers to be important. See J. Richard Hackman, \textit{Group Influences on Individuals in Organizations}, in \textit{Handbook of Industrial and Organizational Psychology} 199, 235-236 (1992).
\item \textsuperscript{160} Id. at 244-245.
\item \textsuperscript{161} See Murphy, \textit{supra} note 145, at 166. See also discussion of unwanted director in Ram Charan, \textit{Boards that Deliver: Advancing Corporate Governance from Compliance to Corporate Advantage} 126 (2005).
\end{enumerate}
shareholder nominations can be achieved, there is indeed reason to think that the shareholder presence on the board would enhance its effectiveness as a control center. First, a shareholder presence would tend to reduce residual conflicts of interest in other control centers. We have seen the need to bolster the independence of the risk management function, internal audit department, and outside auditors by linking them to the board, but the value of these strategies will depend on the actual independence of the board itself. Where the board loses an active relationship with shareholders, this necessary independence may be diminished. Montgomery and Kaufman observe,

When shareholders fail to engage, either in setting direction or holding board members accountable for their behavior, an important link in the governance system is missing. In this context, a director’s allegiance shifts from its proper base – the shareholders – to the nearby boardroom, where fellow directors and management fill the void. This movement skews the governance triangle, moves directors closer to management, and sets the stage for the cordial, consensus-driven environment for which boards are widely criticized.163

Shareholder participation in the selection of directors may be an effective means of connecting the board to the shareholder base and thus assuring needed independence of other corporate control centers reporting to the board.

Secondly, a shareholder presence on the board can serve as an antidote to “groupthink,” the popular expression for group norms that suppress innovation and dissent. In a study of foreign policy fiascos, Irving Janis, the scholar who coined the phrase, showed that groupthink can take root in elite groups with highly qualified members.164 It unquestionably has been a factor

163 Montgomery & Kaufman, supra note 158, at 90.
in corporate scandals from Enron to the 2008 financial crisis\textsuperscript{165} and helps explain the passivity of many corporate boards.\textsuperscript{166} Shareholder-nominated directors, who are likely to come from the same career path as many other directors, may share similar intellectual perspectives, but, with a base in the shareholder constituency, they may be freer to voice dissent and to question management on contentious issues, such as executive compensation, and thus counteract the pressures of groupthink.

As Peterson and Nemeth show, an exposure to dissent can improve decision-making process by stimulating the group to consider multiple perspectives. Even if the dissenting views are wrong, “they unfreeze current opinions and thereby open the possibility of alternative solutions.”\textsuperscript{167} To the same effect, Forbes and Milliken find that “groups performing an intellectual task perform better when their interaction behaviors feature the inclusion of multiple view points and the exchange of both positive and negative comments.”\textsuperscript{168} Such wholesome interaction among directors on a corporate board, however, will occur only in a context of collegiality that supports dialogue and exchange of information.\textsuperscript{169}

\begin{itemize}
\end{itemize}
board, or any other small group, is in itself harmful to performance.170 A shareholder presence on the board thus may improve decision making by generating a free exchange of ideas but only if it does not sow unproductive divisions among members.

Thirdly, decision-making research reveals that, when people make a series of decisions over time, they are prone to follow the judgments implied in earlier decisions. This pattern of behavior, known as escalation of commitment, involves the convergence of several biases.171 When people have some level of commitment to an alternative course of action, they tend to seek out information that supports that alternative, or at least to notice and remember such information.172 More insidiously, they may rely their earlier decision to justify a further step in the same direction; this is the dynamic of foot-in- the-door sales techniques. (“the idea must be good if I have gone this far in considering it.”)173 Again, there is the simple factor of self-justification.174 We all know that people will sometimes throw good money after bad to show that they were right in the first instance. When failure becomes apparent, people tend to attribute it to external

173 Staw & Ross refer to this tendency as self-inference. See Staw and Ross, supra note 172, at 52-53.
174 See Barry M. Staw, Rationality and Justification in Organizational Life, 2 RES. IN ORG. BEHAV. 45 (1980).
circumstances rather than to their own misjudgments, thereby locking themselves into a failing course of action.175

The unitary board of directors is particularly vulnerable to escalation of commitment because directors collaborate in business decisions that they must later evaluate. The problem is particularly acute in financial institutions that specialize on the assessment of risk in a stream of related transactions. European countries have adopted the institutional safeguard of a supervisory board, but this is not a statutory option in the United States and carries its own disadvantages in any event. The unitary board must find other ways to preserve the detachment needed to evaluate the present consequences of past decisions. A shareholder presence on the board potentially counts as a means to this end because it can contribute an outsider’s perspective providing some of the psychological distance often needed for accurate assessment of a course of action.176

The case for a shareholder presence on the board, in short, does not rest on shareholder’s capacity to monitor risk management but on the possibility that that a shareholder presence will enhance the independence and active engagement of the board. We may now turn to the possibility that the new regulation will further this end.

175 Max H. Bazerman, Judgment in Managerial Decision Making 71-72 (6th ed, 2006); Frank Fincham & Miles Hewstone, Attribution Theory and Research, from Basic to Applied, in Introduction to Social Psychology 198, 214-217 (Fincham & Hewstone eds., 3d ed. 2001). Thus, newly hired managers in a declining business are more likely to adopt necessary changes in business strategies. See Vincent L. Barker & Pamela S. Barr, Linking Top Manager Attributions to Strategic Reorientation in Declining First Attempting Turnarounds, 55 J. BUS. RES. 963 (2002).

176 On the importance of an outsider’s perspective, see Colin E. Camerer & Dan Lovallo, Overconfidence and Excess Entry, An Experimental Approach, at 414, in Choices, Values & Frames (Daniel Kahneman & Amos Tversky eds., 2000); Bazerman, supra note 175, at 198-199.
The regulation, rule 14a-11, creates a nomination procedure available to shareholders or shareholder groups with “3% of the total voting power of registrant’s securities that are entitled to be voted on the election of directors,” which have held this qualifying level of stock ownership continuously for three years.\(^\text{177}\) Such eligible shareholders may invoke the procedure to nominate no more than 25 percent of the director positions on the board.\(^\text{178}\) To exercise this right, a shareholder must file with the company and the SEC on Schedule 14N a notice of its intent to require the company to include the shareholder’s nominees in its proxy statement and form of proxy. The notice must be filed between 120 and 150 days before the date that the company mailed its proxy materials for the previous shareholder meeting.\(^\text{179}\) Schedule 14N requires proof of stock ownership and an extensive array of disclosures and representations regarding the shareholder and their nominees.\(^\text{180}\) If the Schedule 14N complies with regulatory requirements, management must include the shareholder nominees in the management proxy accompanied by certain disclosures and statements in support of each nominee not to exceed 500 words.\(^\text{181}\)

In the event that a company receives more than one Schedule N, it must include in its proxy materials the nominees of the “shareholder or shareholder group within the highest qualifying voting percentage” as of the date of filing the form.\(^\text{182}\) The regulation addresses the possibility that the prevailing shareholder or shareholder group may nominate candidates for fewer than 25 percent of the positions on the board, but it may be expected that this situation will rarely occur since shareholders who go to the trouble of filing a Schedule N have no incentive to seek less than a full complement of

\(^{177}\) 17 C.F.R. § 240.14a-11(b)(1) and (2).
\(^{178}\) 17 C.F.R. § 240.14a-11(d).
\(^{179}\) 17 C.F.R. § 240.14a-11(b)(10).
\(^{180}\) 17 C.F.R. § 240.14a-11(b)(3)-(11).
\(^{181}\) 17 C.F.R. § 240.14a-11(c) and (g).
\(^{182}\) 17 C.F.R. § 240.14a-11(e).
directors. The consequence is a winner-take-all rule; the shareholder or, more likely, the shareholder group, with the greatest voting power will enjoy exclusive access to the management proxy under the nominating procedure.

The SEC noted in its release that the winner-take-all rule presents the risk that companies will form relationships with compliant shareholder groups willing to act as their “surrogate” in the 14a-11 procedure. But it rejected the option of limiting each shareholder or shareholder group to a single nominee, as advocated by three banks in our sample, and adopted a more problematic remedy: nominating shareholders must represent on Schedule N that they do not have “an agreement with the registrant regarding the nomination of the nominee.” Recognizing that the rule may chill constructive negotiations between a company and shareholders, the regulation provides a clarification and an exception. It clarifies that discussions between a company and shareholders “limited to whether the registrant is required to include the shareholder nominee” in its proxy statement will not give rise to an agreement and explicitly sanctions discussions between a company and shareholders after the Schedule N has been filed. Moreover, it provides that, if the company agrees to include a shareholder nominee in its proxy statement, “the nominee will be considered

183 17 C.F.R. § 240.14a-11(e). In such a case, the company must include a nominee or nominees from the shareholder or shareholder group with the next highest qualifying voting power percentage. If these nominees with second priority exceed the maximum number allowed under the procedure, the shareholder or shareholder group “may specify which of its nominees are to be included in the registrant’s proxy materials.” Instruction 2 to paragraph (e).
184 Final Rule, supra note 149, at 117.
186 17 C.F.R. § 240.14a-11(b)(7).
187 17 C.F.R. § 240.14a-11 (b)(7), Instruction to paragraph (b)(7).
a shareholder nominee for purposes of calculating the maximum number of
shareholder nominees” in the proxy statement.188

The new regulation unquestionably represents a bold experiment.
Responding to the apparent mandate of fair corporate suffrage in section 14
of the Exchange Act of 1934, the SEC has five times approached the matter of
facilitating shareholder access to the management proxy – in 1942, 1978,
2003, and 2009 – only to back away.189 The effect of the regulation, for good
or ill, will depend on the response of shareholders and corporate governance
committees. Neither can be predicted with confidence.

It may be hoped that the regulation will stimulate, in some companies,
a process of collaboration with shareholder groups allowing the governance
committee to participate in vetting prospective shareholder nominees, despite
the obstacle of the no agreement rule. The success of the regulation, I
suggest, will be measured by the extent that this occurs. The winner-take-all
nature of the nominating procedure, however, seems to rule out any broad
participation of a range of shareholder constituencies on any one board, thus
diminishing the regulation’s potential to infuse an outsider’s perspective into
board room deliberations.

In particular, the winner-take-all character of the regulatory scheme
seems likely to militate against the participation of pension plans and
endowments, which are subject to rigorous diversification standards.190
Though pension plans hold about a fourth of the U.S. equity market, the
ownership stake of individual funds in particular companies tends to be quite
low.191 A survey of the 25 largest corporations in 2004 revealed that only 2 or
3 pension funds typically placed among the top 25 institutional investors and

188 17 C.F.R. § 240.14a-11(d)(4); Final Rule, supra note 149, at 147-148.
189 See Murphy, supra note 145, at 134-144.
191 Id. at 503-504.
their stock holdings nearly always placed them below the top 10. Only one pension fund, TIAA-CREF, was the consistently ranked among the top 25 investors and the largest public pension funds, such as CalPERS, which made the top 25, usually held no more than 0.5 percent of the total stock of the company.\footnote{\textit{See} The Conference Board, The 2005 Institutional Investment Report 38-50 (2005).} If pension plans and endowments remain effectively excluded from the management proxy because of diversification requirements,\footnote{See Murphy (2007), supra note 138, at 512-563. Argues that effective pension fund participation in corporate governance is impeded not only by needed (but sometimes excessive) diversification policies but by redundant legal restrictions, fiduciary conflicts of interest, and other misplaced policies.} as seems likely, the regulatory scheme will in the end provide a much weaker antidote to the corporate tendency toward groupthink.

A skeptical view would be that the regulation is likely to generate an unintended consequence: a slide toward implicit surrogate relationships with particular shareholder groups willing to support management’s efforts to maintain the status quo. The effect would be to complicate the task of governing the publicly held corporation without improving the decision-making process. If so, the search will continue for a means of incorporating a shareholder voice in corporate governance. Since the shareholder base is divided between individual shareholders and different categories of institutional investors, a shareholder voice necessarily implies the participation of minority shareholder coalitions drawn from different shareholder constituencies. But minority shareholders have no incentive to organize to nominate directors if that power is beyond their grasp. They would have this power only in a system of cumulative voting, which creates a kind of proportional representation of minority shareholders.\footnote{The prevailing system, of electing corporate director, sometimes called “straight voting,” tends to deprive minority shareholders of any significant chance of electing their nominee. It requires a separate election context for each vacancy and the vote of a simple majority (or plurality) determines who}
reflections lead to the possibility of taking a new look at the remedy originally proposed by the Banking Act of 1933.

It should be noted that cumulative voting is a moderate idea because it is compatible with a rule of one nomination per shareholder group as advocated by banking representatives. Under a system of cumulative voting, it would be unnecessary, and undesirable, to give any one shareholder group the right to nominate multiple candidates through the 14a-11 procedure because the participation of several shareholder coalitions could be expected to produce a full and, in most cases, a roughly representative complement of shareholder nominations. Cumulative voting would also render the no-agreement rule unnecessary by eliminating the risk of surrogate management/shareholder relationships. Stable and ongoing relations between governance committees and shareholder groups would be furthered by allowing them to engage in unrestricted discussions regarding prospective director candidates. The Financial Services Roundtable suggests a helpful condition to spur such constructive dialogue. Nominating shareholder groups, it suggests, should make their candidates available for interviews as a condition to requesting their inclusion in the management proxy. Other corporate organizations, including JP Morgan Chase, have advocated restrictions on resubmissions as a means of protecting

is elected. Ordinarily, a block of shareholders passively following management recommendations will elect candidates for all vacancies in an election. Cumulative voting confers on each shareholder a number of votes determined by multiplying the number of their shares by the number of director vacancies and allows shareholders to cast all their votes for one or more candidates. The intended result is to create a kind of proportional representation of all shareholder groups. See Amihai Glazer, Debra G. Glazer & Bernard Grofman, Cumulative Voting in Corporate Elections: Introducing Strategy into the Equation, 35 S.C. L. Rev. 295 (1984); Lewis R. Mills, The Mathematics of Cumulative Voting, 1968 DUKE L.J. 28.

See supra note 185.

management from harassment by rogue shareholder groups. The idea can easily adapted to a cumulative voting system. If a shareholder nominee should fail to receive a certain percentage of the votes required for the election of a director under cumulative voting, the nominating shareholder or shareholder group might be barred from making other nominations through the 14a-11 procedure for a period of 2 or 3 years.

A nominating scheme based on the practice of cumulative voting would, of course, would require a legislative mandate comparable to the Banking Act of 1933, and, like the present regulation, it would be an experiment depending for its success the response of corporations and shareholders. It cannot be seriously proposed for the breadth of corporate America without an adequate body of experience. But it is plausible to consider it as a possible experiment confined to the banking industry, which has traditionally been subject to distinct corporate governance rules, including, in the case of national banks, the rule of cumulative voting.

What then is the connection between shareholder nomination process and risk management? The shareholder base is not, and cannot, be regarded as a control center, but the presence of shareholder–nominated directors may strengthen the intellectual independence and active monitoring of the board, or, alternatively, introduce a divisive contingent of directors biased toward short-term business strategies. The practical consequences of the SEC’s newly promulgated regulation are impossible to predict but seem like to produce unintended consequences, leading to a demand for further reforms.

CONCLUSION

\[197\] See Final Rule, supra note 149, at 137-138.

\[198\] In the 1940s, about 40 percent of director elections were conducted by cumulative voting, but the practice has dwindled in the face of management opposition to less than 10 percent today. See Murphy(2010), supra note 138, at 483.
While the subject of corporate governance extends to issues ranging from corporate citizenship to the decision-making processes, the focus of this article on risk management of large bank holding companies justifies a narrower inquiry into the control centers of the corporation. Three are clearly relevant: the risk management departments themselves, the audit function and particularly internal audit, and the contingent of independent directors on the board. A fourth, the shareholder base, is problematic. My survey of corporate governance disclosures reveals a need for more progress in assuring the independence of the risk management and internal audit functions by linking them more closely to the board. This remedy leads to the question of the board’s own capacity to function as an independent control center. The critical issue relates to internal board leadership empowering it to effectively scrutinize management policies and impartially award appropriate executive compensation. Some large bank holding companies have responded to the need for board leadership by separating the positions of CEO and Board chairman or by expanding the responsibilities of the lead director, but progress has been limited and contested. As an alternative approach to board accountability, the SEC has issued final rules establish procedures to facilitate shareholder access to the management proxy. The prospects of this regulatory scheme are uncertain, but, if it could be achieved, an orderly and collaborative process of selecting qualified shareholder nominees holds the promise of contributing to the independence and engagement of the board.
Appendix A

<table>
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<tr>
<th>Rank</th>
<th>Institution Name*</th>
<th>Website</th>
<th>Total Assets**</th>
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<td>1,228,625,000.</td>
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<td>Popular, Inc.</td>
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Source: Federal Financial Institutions Examination Council, National Information Center, Top 50 Bank Holding Companies (assets in 1,000s, as of 12/31/2009).
Note: listing excludes 11 foreign owned banks, one privately owned bank (GMAC, Inc.), and a financial services corporation that is primarily an insurance company (Metlife, Inc.)

Corporate Governance Disclosures

The article is based on systematic research of the following documents found in most or all corporate websites. (See “investor relations” or “About”)

- Proxy statements for 2009 and 2010
- Audit committee charters
- Governance (or nominating) committee charters
- Risk committee charters (variously named)
- Corporate governance guidelines

Additional information can sometimes be found in the websites themselves, earlier proxy statements, bylaws, and particular policies disclosed by some banks, e.g. shareholder nomination procedures.