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.¹

In the wake of the recent financial crisis, the importance of risk management in financial institutions is evident. Conflicts of interest and insider loyalties have deprived the corporate control centers responsible for risk management of adequate power and independence in dealing with risk. Recent changes in corporate governance reflect an awareness of this problem.

This article examines the publicly disclosed corporate governance practices of twenty-five of the largest bank holding companies, focusing on the control centers of the corporations relevant to risk management: the risk management departments, the audit and internal audit function, and the contingent of independent directors on the board. This survey shows that in the aftermath of the financial crisis, a new consensus on best practices is beginning to emerge in assessing risk management. However, there still remains 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 article also analyzes the recent rules facilitating shareholder access to the management proxy for director elections as a possible means to improve risk management. The new rules may serve to better connect the board to the shareholder base and provide an independent voice to the board, serving as an antidote to board "groupthink." While prospects of this regulatory scheme are uncertain, this article suggests that the success of the new regulation will be measured by the extent to which it stimulates a

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¹ORG. FOR ECON. CO-OPERATION & DEV., CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: KEY FINDINGS AND MAIN MESSAGES, 31 (2009), [hereinafter OECD KEY FINDINGS].
process of collaboration with shareholder groups allowing the governance committee to participate in vetting prospective shareholder nominees.

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.\(^2\) By pointing to poor risk management, the Organisation for Economic Co-Operation and Development ("OECD") identifies an obvious target.\(^3\) 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 that created unprecedented and unmanageable risk: skewed incentives, regulatory capture, passive monetary policy, influx of foreign savings, risk-laden consolidation, misuse of complex financial products, faulty mathematical models, an unregulated shadow banking system, the ill-conceived status of Fannie Mae and Freddie Mac, deception, and irrational optimism. Nevertheless, some U.S. and foreign banks succeeded in steering wide of the risky investments that caused the meltdown.\(^4\) In exploring ways to prevent


\(^3\)OECD KEY FINDINGS, supra note 1, at 31. 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." THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS, 1 (2008).

\(^4\)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 2, at 149-50, 203, 247; Peter Boone & Simon Johnson, Canadian Banking Is Not the Answer, N.Y. TIMES (March 25, 2010, 6:37 AM), http://economix.blogs.nytimes.com/2010/03/25/canadian-banking-is-not-the-answer/.
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 the light of the experience of critical loss and failure throughout the banking system" in the 2008 financial crisis. 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.

In this article, I examine publicly disclosed corporate governance practices of twenty-five of the largest bank holding companies, focusing on the control centers relevant to risk management. I find that risk management was 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 twenty-five 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 forty percent of all bank deposits, fifty

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6See infra Parts II, IV.B.


percent of mortgages, and two-thirds of credit cards. The assets of these four banks represent an astonishing fifty two percent of gross domestic product. The two largest banks, Bank of America and JP Morgan Chase, both have assets exceeding 2 trillion dollars. In contrast, the four smallest banks in our sample have average assets of just over fifty 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.

As the recent crisis revealed, the regulation of banking is dictated by the volatility and systemic risks inherent in 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 well capitalized bank may have a debt-equity ratio of 12:1—and they conduct a high volume, low margin business. They are uniquely susceptible to liquidity risk since they are "involved in borrowing short and lending long." 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, as well as short-term maturity instruments such as federal funds and certificates of deposit. 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

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10JoHNSON & KWAK, supra note 2, at 217.
11See NATIONAL INFORMATION CENTER, supra note 8.
12Id.
13See FED. RESERVE BANK OF ATLANTA, THE DIRECTOR’S PRIMER: A GUIDE TO MANAGEMENT OVERSIGHT AND BANK REGULATION, 2 (3d ed. 2002) (assuming eight percent capitalization for the typical bank); Jonathan R. Macey, Commercial Banking and Democracy: The Illusive Quest for Deregulation, 23 YALE J. ON REG. 1, 4-5 (2006); OECD KEY FINDINGS, supra note 2, at 9.
14OECD KEY FINDINGS, supra note 1, at 9; see also MCLEAN AND NOCERA, supra note 2, at 58.
15Macey, supra note 13, at 5.
16Id. at 5-6.
17Id. at 6.
18See Macey, supra note 13, at 6.
banks, represents a major government commitment to the stability of the banking system.\textsuperscript{19} Similarly, Western democracies, including Japan, Sweden, Israel, the Netherlands and France, have all been politically obliged to intervene to prevent the collapse of their banking systems.\textsuperscript{20} 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{21}

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{22} Over the next 150 years, the system fragmented into four federal agencies and fifty state regulators.\textsuperscript{23} 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{24} Following this modest reform, the Federal Reserve System retains jurisdiction over bank holding companies,\textsuperscript{25} 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.\textsuperscript{26} The OCC has more extensive jurisdiction as regulator of national banks, which now account for nearly sixty percent of all banking assets.\textsuperscript{27} National banks predominate among the subsidiaries of seven of the ten largest bank holding companies in our sample.\textsuperscript{28}

\textsuperscript{19}Id. at 7.

\textsuperscript{20}Id. at 8.

\textsuperscript{21}Id. at 8 n.14; Marcel Kahan & Edward Rock, \textit{When the Government is the Controlling Shareholder: Implications for Delaware}, 35 DEL. J. CORP. L. 409, 410-11 (2010).


\textsuperscript{23}See MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION 27-40 (2d ed. 2003) (outlining the Federal and State regulatory structure prior to the passage of Dodd-Frank); see also U.S. GOVT ACCOUNTABILITY OFFICE, GAO-08-32, FINANCIAL REGULATION: INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE, 7-8 (2007) (summarizing the pre-Dodd-Frank financial regulatory scheme).


\textsuperscript{27}See id. at 4.

\textsuperscript{28}See FEDERAL DEPOSIT INSURANCE CORPORATION, INSTITUTIONS DIRECTORY, \textit{available}
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,29 which have been revised and supplemented in later legislation.30 Today, there is a complexity of laws and regulations affecting bank directors with no counterpart in general corporate law.31 Though the Banking Act of 193332 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.33 For example, it limited the number of directors to not more than twenty-five, an important reform at the time since large city banks commonly had more than fifty directors—a practice that shielded both the directors and the banks from accountability.34 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.35 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.36 The regulation addresses the function and organization of the audit committee,

at www2.fdic.gov/idasp/main.asp.

29The National Bank Act, §§9-10.


33See id. § 2 (requiring cumulative voting); see also id. §§ 12-13 (prohibiting executive officers from receiving loans from the bank); id. § 30 (granting Federal Reserve System broad power to remove directors), id. § 31 (limiting the number of directors and minimum stock ownership required).


internal audit, risk assessment, asset quality, interest rate exposure, and excessive executive compensation.\(^\text{37}\)

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,"\(^\text{38}\) The Securities Exchange Act of 1934, as amended in 1964, applies to bank securities but its enforcement is entrusted to federal agencies regulating banks.\(^\text{39}\) 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.\(^\text{40}\)

There is thus ample precedent and justification to tailor corporate governance rules to the peculiar requirements of the banking industry. As Professor Chaffins observes, financial institutions are "a breed apart" for purposes of corporate governance.\(^\text{41}\) This article will address matters calling for review of existing banking laws and regulations, which may not have any application to non-financial firms. Parts II and III 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. Part IV 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. Part V will consider

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41 Brian R. Chaffins, 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, 9 FRBNY ECON. POL’Y. REV. 91, 102 (2003) (arguing that the fiduciary duties 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?, 9 FRBNY ECON. POL’Y. REV. 123, 124 (2003) (finding "systematic differences" between governance of banks and manufacturing firms).
the problematic value of a shareholder role in risk management in 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 also 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 twenty-five 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 requires the audit committee to "[d]iscuss policies with respect to risk assessment and risk management." 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 exposures and

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44 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 Pays for a Rush to Risk, N.Y. TIMES, Nov. 23, 2008, at A1.
the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management. . . .47

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.48 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 "[e]ffective risk assessment" and identify credit risk and interest rate risk.49

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; and (3) they fail to insist on safeguards for the independence of the risk managers.50

The responsibility of the board of directors for risk management is affirmed in the manuals and circulars of all the principal bank regulatory agencies.51 A circular published by The Federal Reserve states:

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 . . . . [A]ll 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.52

47Id. at § 303A.07(b)(iii)(D) cmt.
48Id.
50BASEL COMM. ON BANKING SUPERVISION, BANKS FOR INT'L SETTLEMENTS, SOUND PRACTICES FOR THE MANAGEMENT AND SUPERVISION OF OPERATIONAL RISKS 6-8 (2003) (noting that these corporate governance mechanisms are necessary for developing an appropriate risk management environment).
The OCC advises that, to manage risk effectively, the board must establish "the organization’s risk tolerance" and guide the "strategic direction for managing risk." 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 practices have been established." This essential role of the board in overseeing risk is also reflected in the international standards of the Basle Committee on Banking Supervision, the Financial Stability Forum and the Financial Reporting Council of the United Kingdom.

As a practical matter, the daunting task of establishing firm-wide risk management systems in large diversified financial institutions calls for a 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 treat risk management as a core responsibility. Quite apart from regulatory policy, this duty could be implied from generally accepted corporate
governance principles. However, 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. As of this writing, among the twenty-five banks in our survey, nineteen had a separate board risk committee.

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.

The charters of risk committees generally describe a sphere of

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62See A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE, § 3.02(a)(3) (1994) (stating that directors must "[r]evie[we] and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions"). Indeed, the assessment and management of risk, along with providing a payments mechanism for society, are two of the "core functions of the banking system." Stiglitz, supra note 2, at 5.

63See OECD KEY FINDINGS, supra note 1, at 39.


65Appendix A, risk committee charters.

66WALKER, supra note 5, at 93.
responsibilities quite outside the normal activities of an audit committee. 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.

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. It may be better able to carry out these functions if relieved of its responsibility over risk methodology and strategic planning, which 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. An OCC Manual observes that "[s]ound risk management systems . . . have several things in common; for example, they are independent of risk-taking activities." 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 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

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67 See Appendix A, risk committee charters.
68 See Appendix A, risk committee charter (PNC Bank).
69 See WALKER, supra note 5, at 94; OECD KEY FINDINGS, supra note 1, at 39.
70 See SUPERVISION MANUAL, supra note 52, at § 2125.0.1.3; see also OFFICE OF THE COMPTROLLER OF THE CURRENCY, BANKING CIRCULAR, RISK MANAGEMENT OF FINANCIAL DERIVATIVES BC-277, at 7 (Oct. 27, 1993); OECD KEY FINDINGS, supra note 1, at 9.
should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.72

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.73 Three charters established after the 2008 financial crisis take the additional step recommended by the Walker report. The Morgan Stanley charter directs the risk committee to: "[a]pprove 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."74 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.75

Interestingly, two large banks, continuing an older practice, put the chief risk officer on parity with the director of internal auditing. Large bank holding companies almost uniformly condition the appointment and tenure of the director of internal auditing on the approval of the auditing committee.76 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.77

Nevertheless, the practice of requiring the risk manager to report to the same executive who determines his pay and bonuses still persists in several major banks,78 and according to a 2007 study of the Conference

72Walker, supra note 5, at 99.
73See Appendix A, risk committee charters.
74See Appendix A, risk committee charter (Morgan Stanley).
75See Appendix A, risk committee charters (Citigroup and Northern Trust).
76In our sample, 24 banks require audit committee approval of the appointment and tenure of the chief internal auditor; one, Northern Trust, is silent on the issue. See Appendix A, audit committee charters.
77See Appendix A, audit committee charters (U.S. Bancorp and Keycorp).
Board, only sixteen 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

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

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79 See OECD KEY FINDINGS, supra note 1, at 39.
80 Several risk committee charters allude to such committees. See, e.g., Appendix A, risk committee charters (Bank of America, PNC Financial Services Group, Suntrust Bank Inc., Regions Financial Group, and Huntington Bancshares).
controls relating to accuracy in financial reporting.\textsuperscript{84} 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.\textsuperscript{85} 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.\textsuperscript{86}

In theory, the interests of the outside auditor should be aligned with those of the audit committee since 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 including a financial expert.\textsuperscript{87} 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.\textsuperscript{88} 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


\textsuperscript{85}See PUB. CO. ACCOUNTING OVERSIGHT BD., AUDITING STANDARD NO. 5, at ¶ 10-12 (2007).

\textsuperscript{86}See LOWENSTEIN, supra note 43, at 113.

\textsuperscript{87}Sarbanes-Oxley Act, §§ 202, 301 & 407, amended by Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376. 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. See 17 C.F.R. § 229.407(d)(5)(ii) (2010) (defining financial expert).

\textsuperscript{88}See, e.g., Karl Hackenbracht & Mark W. Nelson, Auditors' Incentives and Their Application of Financial Accounting Standards, 71 ACCT. REV. 43 (1996) (reporting on an experiment measuring whether auditors with an incentive to do so are more likely to use aggressive reporting methods); Joel S. Demski, Corporate Conflicts of Interest, 17 J. ECON. PERSP. 51, 56-59 (2003) (discussing conflicts of interests in auditors); Don A. Moore, et al., Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling, 31 ACAD. MGMT. REV. 1, 7-10 (2006) (noting how conflicts of interests can affect judgment); Max H. Bazerman, et al., The Impossibility of Auditor Independence, SLOAN MGMT. REV. 89 (1997) (assessing the difficulties auditors face in trying to remain objective).
The less heralded function of an 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 also those pertaining to legal compliance and the general effectiveness of the organization. In this respect, the work of internal audit overlaps 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 the organization 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 audits potentially give 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

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89 See infra Part IV (text accompanying notes XX).
90 See generally, COMM. OF SPONSORING ORGS OF THE TREADWAY COMM. ("COSO"), INTERNAL CONTROL-INTEGRATED FRAMEWORK 11-83 (1992) (providing the generally accepted framework for internal auditing); see also OECD KEY FINDINGS, supra note 1, at 35-37 (referencing the 1992 COSO report); Inst. of Internal Auditors, Putting COSO's Theory into Practice, TONE AT THE TOP at 1 (2005) (noting that the 1992 COSO report serves as the "blueprint for establishing internal controls"). 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 COSO, http://www.coso.org (follow "About Us" hyperlink); COSO, http://www.coso.org (follow "Internal Control" hyperlink).
91 BASEL COMM. ON BANKING SUPERVISION, INTERNAL AUDIT IN BANKS AND THE SUPERVISOR'S RELATIONSHIP WITH AUDITORS 3 (2001) [hereinafter BASEL INTERNAL AUDIT]; see also SUPERVISORY LETTER, supra note 52, at 10 (noting that controls should be tested by internal audit); FDIC, RISK MANAGEMENT, supra note 31, at 4.1-4 (stating that a reliable internal audit function is an important element of an internal control system).
92 SUPERVISION MANUAL, supra note 52, § 1050.1.3.1.1.
93 See, e.g., Appendix A, audit committee charter (Bank of America).
94 BASEL COMM. ON BANKING SUPERVISION, ENHANCING CORPORATE GOVERNANCE FOR BANKING ORGANISATIONS, at 13 (2006) [hereinafter BASEL CORPORATE GOVERNANCE].
the late 1990s, it is a formidable challenge to conduct the internal auditing necessary to identify, monitor, and control risk-generating activities. The 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."95 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.96 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.97 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.98

Effective internal auditing offers the only hope of enforcing effective risk management policies in such complex institutional settings. The strength of the internal audit is not only a function of adequate resources and technical competence, but the operational independence of the auditors. The guidelines of the Basel Committee on Banking Supervision, the principal 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 carries out its assignments with objectivity and impartiality."99

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95SUPervision Manual, supra note 52, § 1050.1.3.1.1.
97id.
98While it yields certain insights, the report has limitations as a database. It lists the names of companies without indicating their current status and contains an uncertain number of double entries.
99BASEL Internal Audit, supra note 91, at 4.
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 organisation."\textsuperscript{100} 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.\textsuperscript{101} 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 budgets of the internal audit department; some charters also call for review of staffing or compensation.\textsuperscript{102}

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 matter."\textsuperscript{103} 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 discovered by the internal audit function, while reporting to another senior manager on administrative matters."\textsuperscript{104} But it notes this practice of dual reporting creates "potential for diminished objectivity" with respect to "audits concerning the executive to whom he or she reports" and recommends that, if an institution

\textsuperscript{100} BASEL COMM. ON BANKING SUPERVISION, FRAMEWORK FOR INTERNAL CONTROL SYSTEMS IN BANKING ORGANISATIONS 20-21 (1998); \textit{see also} BASEL CORPORATE GOVERNANCE, \textit{supra} note 94, at 14-16.

\textsuperscript{101} See Appendix A.

\textsuperscript{102} \textit{Id.}

\textsuperscript{103} \textit{SUPERVISION MANUAL, supra} note 52, at § 2060.05.1.1.1.

\textsuperscript{104} \textit{Id.}
adopts a dual reporting arrangement, it should specify that the internal audit manager reports "administratively to the CEO."\(^{105}\)

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.\(^{106}\) The OCC manual points, however, to the pitfalls of requiring the manager to report to a senior executive on administrative matters, stating: "Such an arrangement potentially limits the internal audit manager’s independence and objectivity when auditing the senior executive’s lines of business. Thus, chief financial officer, controller, or other similar positions should generally be excluded from overseeing the internal audit activities."\(^{107}\)

Each of the manuals call attention to the importance of shielding the internal audit department from executive interference on such administrative matters as resources, budgets, appraisals, and compensation,\(^{108}\) but the IT Examination Handbook of the Federal Financial Institutions 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."\(^{109}\) 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 a trail of antagonism and lasting grievances. The auditor must be protected from the risk of future noncooperation or harassment, and be assured that his or her interests in career advancement are 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.\(^{110}\) Seven are silent on the matter. The remainder alludes to audit committee approval or advice on

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\(^{105}\) Id.


\(^{107}\) OCC INTERNAL AND EXTERNAL AUDIT, supra note 106, at 14.

\(^{108}\) See, e.g., id. at 13-14.

\(^{109}\) FFIE EXAMINATION HANDBOOK, supra note 106, at 8 n.6.

\(^{110}\) See Appendix A, audit committee charters (Citigroup, Inc. and Bank of New York Mellon Corporation).
budgets, staffing, or, in one instance, compensation but do not appear to authorize the committee to involve itself in detailed administrative matters affecting the internal audit. Many 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. Four continue the criticized practice of requiring functional reporting to the audit committee on audit issues and administrative reporting to a senior executive. Two require administrative reporting to the CEO as recommended by the regulatory agencies. Five state in general terms that the internal audit manager should report to the audit committee, thereby complying with the regulators’ recommendations.

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. But the Interagency Guidelines Establishing Standards of Safety and Soundness again appear to be the appropriate vehicle to formulate industry standards.

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111 See Appendix A, audit committee charters.
112 See Appendix A, audit committee charters (PNC financial Services Group, Suntrust Banks, Inc., Regions Financial Corporation, and Discover Financial Services).
113 See Appendix A, audit committee charters (Capital One Financial Corporation, BB&T Corporation, American Express Company, and Keycorp).
114 See Appendix A, audit committee charters (Wells Fargo and Fifth Third Bank).
115 See Appendix A, audit committee charters (Citigroup, Inc., Morgan Stanley, BNY Mellon, Zions, and Popular, Inc.).
116 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 the scope of internal audit under the COSO definition. See supra note 72. However, 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. See, e.g., Appendix A, risk committee charter (U.S. Bancorp). Others treat it as a separate function, distinct from internal audit and risk management. See, e.g., Appendix A, audit committee charter (BB&T).
117 See supra note 36.
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 "organisational structure of any bank."118 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."119 A similar assumption underlies the exchange rules requiring predominantly independent boards issued in 2003.120 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 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.121

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 creating skewed incentives for risk taking.122 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.123 At the request of the SEC, the exchanges subsequently issued new standards on directorial independence, effective in November 2003, 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

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118 BASEL CORPORATE GOVERNANCE, supra note 94, at 5.
119 Id.
120 See infra, note 121 and accompanying text.
audit committee be composed entirely of independent directors. \(^\text{124}\) 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. \(^\text{125}\) The large bank holding companies in our sample have gone even further. Recent proxy statements report 83% of the directors as being independent. \(^\text{126}\)

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 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. \(^\text{127}\) 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. \(^\text{128}\) The committees frequently also share responsibility for succession planning for top executive positions. \(^\text{129}\)

The 2003 Exchange rules brought a second innovation—"regularly scheduled" executive sessions, conducted outside management’s presence and presided over by a designated director. The NYSE rule states that these


\(^{126}\)See, e.g., Appendix A, 2009 proxy statement (Morgan Stanley).

\(^{127}\)See 17 C.F.R. § 229.407(c) (2010).

\(^{128}\)See James J. Darazsi & Robert B. Stobaugh, THE GOVERNANCE COMMITTEE, 4-5 (Natl Ass'n of Corp. Dir., Director's Handbook Series) (2003). Governance committee charters usually reveal that the committee recommends assignments of directors to particular committees. See, e.g., id. at 41 app. A. (citing the Corporate Governance Guidelines of Ashland Inc. as an example).

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. The practice of appointing a presiding director quickly spread among listed companies. All but one of the bank holding companies in our sample designate a particular director, usually called the lead director, to preside over executive sessions. Though the actual importance of the position and the frequency of executive sessions vary 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 is concerned with 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 presence of the CEO as a source of information and ideas. Acting alone in executive sessions, 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 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. The lead director of Merrill Lynch, Alberto Cribiore, reportedly

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132 See Appendix A, 2009 and 2010 proxy statements, and corporate governance guidelines.
133 See ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS AND THEMSELVES 60-61, 146-47, 152, 160-61 (2009); LOWENSTEIN, supra note 43, at 110, 140.
took the lead in ousting the CEO, Stan O'Neal,134 and the AIG board also met in executive session to effect a change in management,135 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.136 A director notes that, "[i]n general, the board is charged with supervising management, and management is charged with implementing the company's strategy and business plan."137 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.138 A veteran CEO concurs but observes that the collaborative process still involves distinct roles for the CEO and the board.139 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 "the company's strategy needs to pass a very rigorous test, the test of scrutiny by highly competent directors on my board."140

The possibility of the board functioning as an element of the company's checks 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, 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."141 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

135 See SORKIN, supra note 133, at 152.
137 Id. at 938.
138 Id.
139 Id. at 939.
140 See Zinski supra note 136, at 939.
141 See WALKER, supra note 5, at 12.
effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues.\textsuperscript{142}

A rigorous process of scrutiny or challenge can be effectively 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 an 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 those proposals, with minimal consideration of alternatives.\textsuperscript{143} The absence of independent board leadership (encouraging directors to express objections and to weigh all available options) is enough to explain the failure of 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.

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 the only member of the board with a current executive position in the bank.\textsuperscript{144} 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.\textsuperscript{145} There is, however, no one-size-fits-all formula. The best arrangement to assure board access to inside information

\textsuperscript{142}Id.

\textsuperscript{143}Laboratory studies found "groups with directive leaders used less available information, suggested fewer solutions," exercised more self-censorship, and were more likely to discourage dissent. James K. Esser, Alive and Well after 25 Years: a Review of Groupthink Research, 73 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 116, 131 (1998).

\textsuperscript{144}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).

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 a 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 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 information provided 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.146 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 on the governance committee (in the case of Citigroup serving as chairman of the governance committee), giving him a strong position over all internal board affairs.147

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

147 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 FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE, § B.2.1 (2010) (stating that "[t]he chairman or an independent non-executive director should chair the [nominating] committee").
six largest bank holding companies (other than Citigroup) to create an independent board chairmanship. The Bank of America adopted an independent chairmanship in 2010, a 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 CEO, approve Board meeting schedules to ensure there is sufficient 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 director’s responsibilities. Capital One Financial Corporation states in its corporate governance guidelines only that the lead director may "[s]uggest 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.

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149 See Appendix A
150 See Appendix A, corporate governance guidelines, (the actual number is 10).
151 See Appendix A, BB&T Corporation, corporate governance guidelines.
152 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.
153 See Appendix A, 2009 and 2010 proxy statements.
154 See Appendix A, corporate governance guidelines, (the actual number is 13).
155 See Appendix A, 2010 proxy statement (U.S. Bancorp).
156 Capital One Fin. Corp., Corporate Governance Principles, 7 (February 1, 2010).
of the internal affairs of the board. 157 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, 158 but they are likely to be worthless in promoting controversial change. For example, disclosure has been an utter failure in encouraging governance committees to engage in outreach to shareholders. 159 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. 160 The alternative of prescriptive guidance can define and consolidate practices that are generally recognized to be desirable, but it 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. 161

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 audit 162—but other provisions are based on an older, hierarchical model of

157 See Appendix A, corporate governance guidelines (Goldman Sachs Group, Inc.); corporate governance committee charter (Huntington Bancshares Inc.); and 2010 proxy statement (Discover Financial Services).
159 See infra notes 184 & 185 and accompanying text.
161 See supra, note 29 (documenting the regulations promulgated by the Interagency Guidelines Establishing Standards for Safety and Soundness currently in force).
the corporation, requiring harsh regulatory discipline of corporate executives.163 Such punitive controls have proven ineffective,164 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.165 The goal of fostering more effective self-regulation, moreover, appears most compatible with the earliest republican values of our country.166

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.167 The Act, however, requires additional personal certifications of the chief financial officer and the chief executive officer.168 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

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163See, e.g., id. at §§ 304, 904, 1106.
164See, e.g., Brian T. FitzPatrick, Congressional Re-election Through Symbolic Politics: The Enhanced Banking Crime Penalties, 32 AM. CRIM. L. REV. 1, 2-5 (1994) (arguing that the motivations behind stricter punishment for banking crime are not their effectiveness); see also IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 77-78 (1992) (observing that front-end improvement of the decision-making process can be more effective than back-end sanctions for harmful conduct).
165See Michael E. Murphy, Pension Plans and the Prospects of Corporate Self-Regulation, 5 DEPAUL BUS. & COM. L. J. 503, 563-77 (2007) [hereinafter Murphy Pension Plans]; Michael E. Murphy, Restoring Trust in Corporate America: Toward a Republican Theory of Corporate Legitimacy, 5 NYU J. L. & BUS. 415, 476-77 (2009) [hereinafter Murphy Restoring Trust]; see also Michael E. Murphy, Attacking the Classified Board of Directors: Shaky Foundations for Shareholder Zeal, 65 BUS. LAW. 441, 474 n.288, 477-78 (2010) [hereinafter Murphy, Nominating]
166See Murphy Restoring Trust, supra note 165, at 483-84 (concluding that “a structure of corporate governance shaped by republican ideas is potentially compatible with self-regulation.”).
accounting details and procedures outside the ordinary scope of his or her leadership 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 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. 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 cumulative voting. 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. It was further debilitated by an OCC regulation and corporate bylaws subjecting shareholder nominees to lengthy notice requirements and rendered relatively unimportant by the emergence of bank holding companies unaffected by the cumulative voting rule. Four years ago, shortly before the financial crisis, the mandatory requirement of cumulative voting was finally eliminated in the ironically named Financial

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169 Such formalistic compliance might include appointment of a disclosure committee, documentation of meetings and consultations, and payment of fees.
173 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. 29,089 (Aug. 14, 1986).
Services Regulatory Relief Act of 2006.\textsuperscript{175} This past 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.\textsuperscript{176} The agency had twice issued 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.\textsuperscript{177} When the Dodd-Frank bill broadly confirmed its authority, the SEC issued final regulations.\textsuperscript{178}

The SEC release, Facilitating Shareholder Director Nominations, identified improved risk management as one of the objectives of the new regulation.\textsuperscript{179} 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{180} 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 answer to the negative was vigorously argued by the banking industry in response to the proposed regulations in 2009.\textsuperscript{181} 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.\textsuperscript{182}


\textsuperscript{179}Id. at 56,669.

\textsuperscript{180}Id.


\textsuperscript{182}See Ross Levine, The Corporate Governance of Banks: A Concise Discussion of
Loan quality is difficult to observe, particularly when the loans are extended to businesses that are themselves opaque, or to numerous small borrowers through different intermediaries. 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. If the removal of CEOs of failing firms came too late to count as a risk management measure, shareholder action is even less likely to provide a timely remedy as it is tied to annual or special meetings. In addition to being in a poor 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 managers (whose position and reputation 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

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183See id.

184Id.


186As might be expected, ratings agencies disagree more often over bank bond issues than over other similar issues. See id. at 874, 887.

187Banks however, have proven, 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. BUS. 33, 34 (2001).

188Letter from Wachtel, Lipton, Rosen & Katz, to Elizabeth M. Murphy Sec'y SEC, 4-5 (Aug. 17, 2009).
qualifications, if any, set forth in the registrant’s governing documents.\footnote{Disclosure required for Shareholder Nominations, 75 Fed. Reg. 56,668, 56,791(Sept. 16, 2010) (to be codified at 17 C.F.R. §240.14a-11).} 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."\footnote{Editorial, N.Y. TIMES, June 20, 2010, at WK.7.} But a director’s influence in the small and cohesive groups that comprise corporate boards proceeds from trust and dialogue among members. New board members join a small group with well established norms that typically place a high value on collegiality.\footnote{See Cynthia A. Montgomery & Rhonda Kaufman, The Board's Missing Link, HARV. BUS. REV., March 2003, at 86, 90; Rakesh Khurana, Searching for a Corporate Savior 83-84 (2002).} The board in fact 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.\footnote{Social psychology teaches that, in small groups, a 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 a priori.\footnote{See id. at 244-45 (noting that groups will often make efforts to persuade the deviant of the group's viewpoint before rejecting them). \cite{Social psychology teaches that, in small groups, a 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 a priori.\footnote{See id. at 244-45 (noting that groups will often make efforts to persuade the deviant of the group's viewpoint before rejecting them).} See Rakesh Khurana, Searching for a Corporate Savior 83-84 (2002).} 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.\footnote{See Murphy Directors, supra note 172, at 166; see also Ram Charan, Boards That Deliver: Advancing Corporate Governance from Compliance to Competitive Advantage 154-55 (2005) (discussing the assessment of new directors). \cite{See Jeffrey A. Sonnenfeld, What Makes Great Boards Great, HARV. BUS. REV. Sept. 2011] ASSURING RESPONSIBLE RISK MANAGEMENT IN BANKING 153} 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.\footnote{See id.}
The opposing 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 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.197

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.198 It unquestionably has been a factor in corporate scandals from Enron to the 2008 financial crisis, and helps explain the passivity of many corporate boards.199

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197 Montgomery & Kaufman, supra note 191, at 90.
199 See James Fanto, Whistleblowing and the Public Director: Countering Corporate Inner
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.\footnote{Randall S. Peterson & Charlan J. Nemeth, Focus Versus Flexibility: Majority and Minority Influence Can Both Improve Performance, 22 PERSONALITY \& SOC. PSYCHOL. BULL. 14, 15 (1996).} Even if the dissenting views are wrong, "they unfreeze current opinions and thereby open the possibility of alternative solutions."\footnote{Id.} To the same effect, Forbes and Milliken find that "groups performing an intellective task perform better when their interaction behaviors feature the inclusion of multiple viewpoints and the exchange of both positive and negative comments."\footnote{Daniel P. Forbes \& Frances J. Milliken, Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups, 24 ACAD. MGMT. REV. 489, 494 (1999).} 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.\footnote{See Ram Charan, Conquering a Culture of Indecision, HARV. BUS. REV., Jan. 2006, at 108.} Conflict between members of the board, or any other small group, is in itself harmful to performance.\footnote{See Carsten K. W. De Dreu \& Laurie R. Weingart, Task Versus Relationship Conflict, Team Performance, and Team Member Satisfaction: a Meta-Analysis, 88 J. APPLIED PSYCHOL. 741, 746-48 (2003).} 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.\footnote{See Max H. Bazerman et al., Escalation of Commitment in Individual and Group Decision Making, 33 ORG. BEHAV. \& HUM. PERFORMANCE 141, 141-42 (1984); F. David Schoorman, Escalation Bias in Performance Appraisals: An Unintended Consequence of Supervisor Participation in Hiring Decisions, 73 J. APPLIED PSYCHOL. 58, 58-59 (1988); Jerry Ross \& Barry M. Staw, Expo 86: An Escalation Prototype, 31 ADMIN. SCI. Q. 274, 274-75 (1986) (exploring whether "individuals become overly committed in escalation situations").} 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. More insidiously, they may rely on their earlier decision to justify a further step in the same direction; this is the dynamic of foot-in-the-door sales technique ("the idea must be good if I have gone this far in considering it.") Again, there is the simple factor of self-justification. 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 circumstances rather than to their own misjudgments, thereby locking themselves into a failing course of action.

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 in 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.


207 Staw & Ross refer to this tendency as self-inference. See Staw and Ross, supra note 205, at 52.

208 See Barry M. Staw, Rationality and Justification in Organizational Life, 2 RES. IN ORG. BEHAV. 45, 55 (1980).

209 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, 214-17 (Hewstone & Stroebe 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 Firms Attempting Turnarounds, 55 J. BUS. RES. 963, 966 (2002).

210 See Steven Hill, Europe’s Answer to Wall Street, NEW AMERICA FOUNDATION (April 21, 2010), http://workforce.newamerica.net/publications/articles/2010/europe_answer_to_wall_street_30951.

211 See Colin E. Camerer & Dan Lovallo, Overconfidence and Excess Entry: An Experimental Approach, in CHOICES, VALUES & FRAMES 414, 422-23 (Daniel Kahneman & Amos Tversky eds., 2000) (noting the importance of an outsider's view); see also Bazerman, supra note
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 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.

The regulation, Rule 14a-11, creates a nomination procedure available to shareholders or shareholder groups with "3% of the total voting power of the 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. Such eligible shareholders may invoke the procedure to nominate no more than twenty-five percent of the director positions on the board. 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. Schedule 14N requires proof of stock ownership and an extensive array of disclosures and representations regarding the shareholder and their nominees. 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.

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 nominating shareholder group with the highest qualifying voting power percentage" as of the date of filing the form. The regulation addresses the possibility that the prevailing shareholder or shareholder group may nominate candidates for fewer than twenty-five 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 directors. The consequence is a

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205, at 198-99 (stating that the outsider tends to be a better decision maker than the insider).
213Id. at 56,785.
214Id. at 56,784.
215Id.
216Shareholder Nominations, 75 Fed. Reg. at 56,784.
217Id. at 56,785.
218Id. at 56,786.
219See id at 56,786. 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
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 a shareholder nominee for purposes of calculating the maximum number of shareholder nominees" in the proxy statement.

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 approached the matter of facilitating shareholder access to the management proxy in four prior instances—1942, 1978, 2003, and 2009—only to back away. 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

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." Id.

224Id.
225See Murphy Directors, supra note 172, at 133-145.
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
dependments, which are subject to rigorous diversification standards.226
Though pension plans held about a fourth of the U.S. equity market by 2005,
the ownership stake of individual funds in particular companies tended to be
quite low.227 A survey of the twenty-five largest corporations in 2004
revealed that only two or three pension funds typically placed among the top
twenty-five institutional investors, and their stock holdings nearly always
placed them below the top ten.228 Only one pension fund, TIAA-CREF, was
consistently ranked among the top twenty-five investors.229 The largest public
pension funds, such as CalPERS, which made the top twenty-five, usually
held no more than 0.5 percent of the total stock of the company.230 If pension
plans and endowments remain effectively excluded from the management
proxy because of diversification requirements,231 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

226 See Murphy Pension Plans, supra note 165, at 506-12 (discussing the interplay between
fiduciary duties and cost considerations); see id. at 521 n.101 (noting federal regulation that treats
endowment funds and church plans in parity with pension plans).
227 Id. at 503-04.
228 See THE CONFERENCE BD., THE 2005 INSTITUTIONAL INVESTMENT REPORT 38-50
(2005).
229 See id.
230 See id.
231 See Murphy Pension Plans, supra note 165, at 512-63 (arguing 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).
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. These 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 management from harassment by rogue shareholder groups. The idea can

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232The 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 contest for each vacancy and the vote of a simple majority (or plurality) determines who 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 generally Amihai Glazer, et al., Cumulative Voting in Corporate Elections: Introducing Strategy into the Equation, 35 S.C. L. REV. 295 (1984).

233See supra note 221 and accompanying text.


235See Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56.706 n.400
easily be 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 two or three years.

A nominating scheme based on the practice of cumulative voting would, of course, 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 on the response of corporations and shareholders. It cannot be seriously proposed for the breadth of corporate America without an adequate body of experience.\(^{236}\) It is plausible, however, 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 likely to produce unintended consequences, leading to a demand for further reforms.

VI. CONCLUSION

While the subject of corporate governance extends broadly to corporate decisionmaking 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

\(^{236}\)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 ten percent today. See Murphy, Nominating, supra note 165, at 483.
A 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 establishing 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><a href="http://www.citigroup.com">www.citigroup.com</a></td>
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<td>Wells Fargo &amp; Company</td>
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<td>Morgan Stanley \U.S. Bancorp</td>
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Source: Federal Financial Institutions Examination Council, National Information Center, Top 50 Bank Holding Companies (assets in 1,000s, as
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.