

DG Internal Market and Services/Company Law,  
Corporate Governance and Financial Crime Unit  
European Commission

Submitted by email to  
[markt-cg-fin-inst@ec.europa.eu](mailto:markt-cg-fin-inst@ec.europa.eu)

1 September 2010

Dear Sirs

## **ICSA response to the European Commission Green Paper on corporate governance in financial institutions**

The Institute of Chartered Secretaries and Administrators (ICSA) is the professional body that qualifies chartered secretaries and we appreciate the opportunity to comment on this important issue. In our response we have some general comments followed by some responses to your specific questions.

### **General comments on the Green Paper**

#### **A. Prescription versus 'comply or explain'**

In our view, the complexity and inherent risk of the financial services market calls for specific regulation of capital requirements and other prudential and business conduct matters, as envisaged for example by the G20, but governance issues such as board composition, the role of the shareholders and directors and board performance are best dealt with by a 'comply or explain' framework, as is well developed in the UK, rather than by prescribed regulation. There is a wide diversity of size and scope of financial institutions, including but not limited to banks, asset managers and both life and general (non-life) insurers. They are each subject to different business models and different risks and, in most jurisdictions, different business regulatory frameworks. It would not be appropriate or constructive to extend regulation of them to cover general governance matters. We are very concerned that any such extension of regulation would constitute an erosion of the 'comply or explain' framework.

We strongly support the ‘comply or explain’ model rather than prescription, as it is generally accepted that one size does not fit all. ‘Comply or explain’ gives scope for flexibility, allowing companies to be agile and proactive in their governance approach and permitting them to aspire to, and attain, higher governance standards than might be the case under a prescriptive regime. For this reason we believe it to be better suited to shape helpful governance behaviours than a regulatory approach that can so easily descend into the ‘tick box’ mentality that the Green Paper so rightly criticises.

The Green Paper states that the existing governance principles are ‘too broad in scope and not sufficiently precise’ and give ‘too much scope for interpretation’. This view concerns us greatly. The strength of ‘comply or explain’ is its flexibility. Issues which need to be prescribed for financial services are included in regulation and statute. Other wider governance issues need to retain flexibility to allow companies to choose the most appropriate response to their national governance code which best meets the particular needs of the company and its stakeholders.

The Green Paper argues that the principles have been difficult to put into practice, in most cases leading to box ticking. This appears to contradict the point also made in the Green Paper that there is too much scope for interpretation.

The lack of a legal obligation to comply with a code and the ‘weakness of relevant checks’ and absence of deterrent penalties are all cited as reasons for the ‘ineffective implementation of governance’. We would point out that governance standards have generally, in our view, improved significantly over the last 5 – 10 years, in particular with regard to checks and balances in board composition, audit and internal control, and transparency and disclosure. It is generally accepted, including in the Green Paper itself, that the financial crisis was not caused by a widespread failure of governance, still less of governance models. Furthermore, the vast majority of all financial institutions did not fail during the crisis; many continued to perform satisfactorily during this time. We do not therefore think that the crisis should precipitate a knee-jerk reaction into greater prescription.

Having said that, we agree that improvements can be made in monitoring and accountability. In the UK, for example, we have recently introduced a Stewardship Code for institutional investors, which seeks to encourage greater and more effective shareholder engagement with greater transparency in this regard.

We are disappointed and concerned to see that the Green Paper appears to take a somewhat negative view of ‘comply or explain’, especially since the EU Commission’s Forum of governance experts regards it as the ‘cornerstone’ of EU corporate governance.

## **B. Directors**

The Green Paper criticises directors and in particular asserts:

- They did not devote sufficient resources or time to their role
- NEDs did not question owing to lack of technical expertise or confidence

- They did not come from sufficiently diverse backgrounds
- There was a lack of serious performance appraisal of individual directors and the board as a whole
- Directors were unable to recognise the nature of certain risks and so did not ensure appropriate risk management

We would like to stress again that in our view standards have risen in recent years. This broad attack on directors does not seem to us to be justified.

The Paper concludes that the above points indicate a poor quality appointments procedure. This may be so in some instances, but it is a rather simplistic interpretation. A robust and transparent appointments procedure is indeed extremely important. However, it is not the solution to all these problems and the other issues highlighted need serious attention.

The new UK Governance Code and Walker Recommendations for financial services companies address all these issues to some extent, although their success will be measured over time by the extent to which companies seek to step their governance processes and behaviours up a gear to meet these points.

These issues are best addressed within a flexible ‘comply or explain’ framework, since they are nuanced and difficult to prescribe.

### **C. Risk management**

The Green Paper highlights a lack of understanding of risks and insufficient training. We agree the latter would certainly merit more focus. It also refers to a lack of authority of the risk management function. We agree that this is a key issue. The risk management function is, in our experience, very often not adequately linked into board work, nor indeed to the work of other parts of the organisation both up and down the seniority chain. Many boards need to look more carefully at this to ensure an approach to risk which is embedded in the culture and processes of the organisation.

Poor quality risk information and IT systems are also mentioned. We agree that the quality of information can in some instances be poor, especially when it is insufficiently tailored to the circumstances of the organisation. Boards and shareholders need to consider this as part of their general governance response.

### **D. Auditors**

The section on auditors is confusing, since it suggests that conflicts of interest could arise simply because auditors are remunerated by the company which they audit (we find it difficult to see in what other way auditors could be remunerated for performing their normal audit function) (para 3.7). The section does not mention the potential conflict where an auditor performs (and is remunerated for) non-audit services for a company which it audits. In the UK this is considered to be acceptable provided there is a clear policy concerning the type of non-audit work for which auditors may be engaged, a reasonable balance between remuneration for audit and non-audit services and full disclosure of the respective items of remuneration. In the UK, the oversight of such arrangements by an audit committee comprised of

independent non-executive directors of the company also helps to provide assurance that any conflicts of interest are being properly managed.

### **Specific Questions (using the numbering in the Green Paper)**

- 1.1** We do not support the suggestion that the number of directorships an individual may hold should be limited as this approach does not take into account the time spent or commitment of individual directors. It also takes no account of varying levels of other commitments, not related to directorships, that a director might have.
- 1.2** The market appears in any case to be moving in this direction. Whilst combined CEO/Chairman role is not generally recommended, a prohibition is unnecessarily prescriptive and we do not believe it can be justified. There may be some limited circumstances where it may be sensible to combine the roles. For this reason, whilst we agree with the principle that the roles should be separate, a regulatory rather than a 'comply or explain' approach would not be helpful. In any event, this is a high profile area that, in the UK at least, is very effectively policed by shareholders pressures.
- 1.3** Appointment criteria and director development policies can achieve this. Diversity cannot be prescribed without prejudicing the more important issues of aptitude, commitment, motivation, personal fit and time availability to do the job.
- 1.4** This is a desirable aim but cannot be prescribed and is secondary to the factors in 1.3 above, which are the key factors for effective board composition. We would be against any form of quotas.

We would like to point out that to us diversity means more than more women and people from different backgrounds. Diversity of experience is also important; for example, arguably, financial institutions should not just have people from a financial background on their boards – someone from a non-financial background may be more likely to pose questions which challenge accepted thinking within the financial community and help to avoid problems associated with "herd behaviour". If this is accepted, it argues against a high pre-appointment hurdle of relevant experience, although we fully accept that directors with less sector experience should have a more onerous obligation to educate themselves post-appointment.

- 1.5** The market is moving this way and the recently adopted UK Governance Code provides for external facilitation of board evaluation at least every 3 years for FTSE 350 companies. We would not support making it compulsory as boards may need to approach it gradually, perhaps beginning with an internal evaluation and then building on that later by introducing an external facilitator.

We are strongly of the view that the results of the evaluation (other than a broad summary) should be confidential, otherwise they are likely to be boilerplate. Making results generally available will inhibit directors' openness to the evaluation, significantly decreasing its value.

- 1.6** The Walker report in the UK provides for this. Our view is that specific Risk Committees will be relevant for most, but not necessarily for all, financial services companies. We feel that this is best dealt with as part of financial regulators' assessment of risk governance in regulated firms, rather than as part of a separate set of general governance regulations. This enables the need or otherwise for a board level risk committee to be assessed within the context of the entity's overall risk governance.
- 1.7** Although we can see advantages in this it should be up to the company to decide. In practice, we believe it is unlikely that there would be no overlap.
- 1.8** We would suggest the risk committee chairman should be available at the AGM to answer any questions, as are the chairmen of other board committees in the UK, rather than required to report to the AGM. Under the Shareholders Rights Directive there is of course a requirement to answer questions put to AGMs. We would also point out that narrative reporting requirements and International Financial Reporting Standards both require material disclosure of risk related information in UK Annual Reports.
- 1.9** This would be to discuss, debate, challenge and ultimately to determine risk policy, to review it regularly, and ensure its promulgation, monitoring and enforcement. It is also important for the board to give a lead from the top to the whole organisation on the importance of good risk management processes and behaviour, for instance, by ensuring that strategic decision-making is informed by a strong element of risk assessment.
- 1.10** If this refers to a risk policy we would say yes.
- 1.11** It may be impractical for the board to approve every new product and indeed in some areas 'new product' is a matter of degree not kind. We would suggest that it may be appropriate for the board to approve products that fall outside the previously agreed risk profile or which are a completely new line of business, but that the board should not get involved in the day to day running of business in this way. It should set the parameters and monitor them (as any good risk management system would do) and leave the executive team to execute.
- 1.12** There is already clear risk reporting to the market. A blanket requirement to inform the supervisory authorities of 'any material risks' would not add to this (and would swamp the authorities with 'boiler plate' disclosures). Risk with high impact financial institutions is in any case frequently discussed with the supervisory authorities.
- 1.13** The interests of stakeholders are taken into account in the UK under the Companies Act directors' general duty to promote the success of the company for the benefit of shareholders as a whole, taking account of various other stakeholder interests (s. 172 Companies Act 2006) . However until the company's solvency is in doubt, there is no specific duty to creditors (including depositors).

We believe there may be problems if a specific legal duty regarding depositors, while a company remains solvent, is imposed. This area was considered at length in the Company Law Review which preceded enactment of the Companies Act 2006 (and involved wide consultation) and extension of the directors' duties in this way was not supported. We believe that regulators also cover this point under the "treating customers fairly" regime or its equivalent elsewhere.

### **Risk-related functions**

As a general point, "risk" has a specific meaning in a financial context and we need to be clear that there should not necessarily be a carryover from what is recommended for financial institutions to what we would recommend for other listed companies.

- 2.1** The status of the chief risk officer could be enhanced by reporting lines at senior level, access to the board and its committees, periodic reporting to the board and committees, by the authority and scope of role being well communicated throughout the organisation, and by adequate resource and support.

The status of the chief risk officer should be high as this is a senior role, but we would not say it should necessarily be equal to the CFO.

- 2.2** Communication could be improved by requiring periodic reports to the board committees and the board. There should certainly be an agreed procedure for decision making and communication both up and down the authority chain.
- 2.3** Yes, we agree that the chief risk officer should not only be able to report directly to the board but would expect that he or she would routinely do so through regular reports.
- 2.4** Yes, if necessary, IT can be used to improve information flow. It is arguably more important for the board to decide precisely what information it needs and in what format and to ensure that this is received in a timely manner.
- 2.5** Yes, there should be a requirement to approve a report on the adequacy of internal control.

### **Auditors**

In the UK, auditors are retained by the company and provide information only for the company's use and benefit.

- 3.1** This could put the auditors into a position of conflict.
- 3.2** We are not sure that this is necessary since they would already report on serious matters
- 3.3** We are not sure what is meant here by external auditors' 'control', but presume it refers to their remit (ie whether such information should be audited). The

extension of the audit to risk-related financial information (which is in itself, we suspect, difficult to define) should be a matter for the company to decide. There is a danger that audit could make such information more boiler plate and less helpful and transparent to shareholders. However, we believe auditors should have a duty to report on any risk disclosure which they have found in the course of their work to be untrue or misleading.

### **Supervisory authorities**

- 4.1 The role of the UK FSA in the internal governance of companies is in the process of being redefined and strengthened, particularly in the context of capital adequacy modelling, for instance in preparation for Solvency II in the insurance sector.
- 4.2 We do not believe the supervisory authorities can check the board's 'correct functioning' as such and think this would be impractical and excessive.
- 4.3 In the UK the FSA are proposing to extend their remit to broadly cover this and it will be achieved by interviewing prospective directors and other persons who may have a significant influence on governance matters.

### **Shareholders**

As a general point, the new Stewardship Code in the UK seeks to improve the quality of institutional investor engagement.

- 5.1 We do not think this should be compulsory, especially as the term 'institutional investors' covers a broad range of investors, both long and short term. The UK Stewardship Code aims to promote this disclosure on a voluntary basis.
- 5.2 Please see the UK Stewardship Code. We believe that investors should be encouraged rather than obliged to adhere to a code.
- 5.3 Yes, it is important for companies to be able to establish the identity of their beneficial shareholders. The s793 system works well in the UK. Under this regime a company or its agent may contact a registered shareholder and require to be informed of the identity of the individuals or organisations on whose behalf the shares are held. We have referred to this in greater detail in our response to the recent consultation on the Transparency Directive.

### **Governance implementation**

- 6.1 The legal responsibilities of board members are already extensive in the UK. We do not see how their accountability could be usefully increased.
- 6.2 We would avoid trying to alter civil and criminal liability, especially given the absence of harmonised rules at EU level.

## **Remuneration**

- 7.1** There could be mandatory disclosure and shareholders' advisory vote, as currently works well in the UK.
- 7.2** We are unsure which problems may need addressing here. However, in principle we would not support EU level regulation and we would certainly be against the prohibition of stock options, which are a useful element of remuneration for many companies. Note that stock options are not just granted to directors and senior executives, and that all-employee options are also in use.
- 7.3** No, we do not believe that the tax treatment promotes risk-taking. The favourable tax treatment is up to a value of £30,000 in the UK, which is a very low level.
- 7.4** No, we do not think that this is practical, or desirable. Shareholders in the UK already have an advisory vote on remuneration and prior approval of share incentive plans. Companies in the UK are obliged to disclose a great deal of information about individual directors' remuneration and about remuneration policy generally. They are also able to engage directly with shareholders, whose identity is known or can be ascertained by means of our s793 procedure. The level and type of remuneration is therefore a matter between the company and its shareholders. Shareholders would not wish to vote in favour of excessive remuneration packages. It is this relationship which provides the check against excesses. It allows for companies to develop packages that are appropriate to their circumstances and explain them to shareholders, who can then decide how to vote. In our view this is more effective and flexible than prescribing specific practices. It also serves as a practical example of why 'comply or explain' works better than prescription.
- 7.5** Part of the problem is the length of the contractual term. The typical (rolling) term for a UK director is 12 months, leading to lower severance payments than in countries where longer contractual terms are the norm.

Various guidance in the UK – and we imagine elsewhere – over the years has sought to restrict 'rewards for failure'. In practice there are often legal problems concerning the definition of failure or of 'effective performance'.

- 7.6** No, we do not think it is possible to generalise about this.

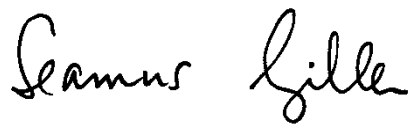
## **Conflicts of interest**

- 8.1** A distinction must be drawn between (i) corporate governance arrangements aimed at avoiding or managing conflicts of interest within the company e.g. conflicts between the personal interests of a director (or a major shareholder) and the interests of the company; and (ii) conflicts which arise in financial markets, external to the company e.g. if a company is marketing investments in a particular asset while at the same time on its own account taking short positions in that asset.

The Green Paper on corporate governance should presumably focus on conflicts within category (i) above. We believe that there should be legally binding rules concerning such conflicts which should be harmonised as far as possible within the EU – we believe that the UK has well developed (and recently reviewed) rules in this area – contained mainly in Part 10, Companies Act 2006.

8.2 This question appears to fall within category (ii) (as mentioned in 8.1 above) and thus does not really relate to corporate governance but rather to market regulation.

Yours faithfully

A handwritten signature in black ink that reads "Seamus Gillen". The signature is written in a cursive, flowing style.

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