The Law Society
of England and Wales

European Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies

Response of the Law Society of England and Wales and the City of London Law Society

1 September 2010

ETI Registration No. 24118193117-34

supporting solicitors

Response submitted on behalf of the Law Society of England and Wales and the City of London Law Society

Content ....………….Page

Contact information

For further information, please contact:

Andrew Laidlaw
Deputy Head of Office
The Joint Brussels Office of the Law Societies
85 Avenue des Nerviens, Box 10
B-1040 Brussels, Belgium
Tel +32 (0) 2 743 85 85
Fax +32 (0) 2 743 85 86
Email: andrew.laidlaw@lawsociety.org.uk

Richard Ufland
Partner, Hogan Lovells
Chairman, Company Law Committee of the Law Society of England and Wales
Tel: +44 (0)20 7296 2000
Email: richard.ufland@hoganlovells.com

European Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies, COM(2010) 284

This response has been prepared jointly by the Company Law Committee of the Law Society of England and Wales and by the City of London Law Society Company Law Committee and Regulatory Committee.

The Law Society of England and Wales is the representative body of over 120,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena. This response has been prepared on behalf of the Law Society by members of the Company Law Committee. The committee is made up of senior and specialist corporate lawyers.

The City of London Law Society (CLLS) represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees and in this case the response has been prepared by the CLLS Company Law Committee and the CLLS Regulatory Committee.

We are pleased to have the opportunity to comment as part of this consultation on corporate governance in financial institutions. Whilst we recognise the importance of good corporate governance within the EU, we should like to make some general points in relation to legislation in this area.

In our view corporate governance is a developing and evolving area and it is particularly ill-suited to legislation and prescription. What is right for one company and set of stakeholders is inappropriate for another and in general the standards of corporate governance expected of or appropriate for companies needs to be proportionate to their size and the risks which they face.

We have benefited in the UK from a best practice Code of Corporate Governance applied on a 'comply or explain' basis. We believe that a comply or explain approach to corporate governance allows the standards to be set higher than would be the case if Member States had to agree on a legislative approach and that the standards can be reviewed and adjusted more frequently than would be the case for legislation. Whilst in the case of banks and financial institutions (BOFIs) corporate governance requirements may be bolstered by supervisors/regulators imposing specific compliance requirements, we still believe that a code of best practice chosen by each Member State is the correct underlying approach.

We should also note that we consider some of the points made in the consultation in relation to BOFIs to be well made, but we do not consider that the same points hold true for companies which are not BOFIs and in particular we consider that it is only in the case of BOFIs that compliance with corporate governance standards may need to be made subject to supervision or regulation by any external bodies in addition to shareholders.

We consider excessive regulation of BOFIs to be a threat to the competitiveness of the EU and its markets. We hope that consideration will be given both to the huge amount of change that has already occurred in relation to the corporate governance of BOFIs and to the cost of compliance with new EU legislation which is imposed over member state practice which is already functioning effectively in most cases.

References:

UK Corporate Governance Code available at
http://www.frc.org.uk/corporate/ukcgcode.cfm

Walker Recommendations:
http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf (Sir David Walker carried our a review of corporate governance in UK banks and other financial industry entities and this paper sets out his recommendations)

CP10/3 - Financial Services Authority Effective corporate governance (Significant influence controlled functions and the Walker review):
http://www.fsa.gov.uk/pubs/cp/cp10_03.pdf (This paper sets out measures which the UK Financial Services Authority proposes introducing in the light of Sir David Walker's recommendations.)

1. General question 1: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

Specific questions:

1.1 Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

No, there should not be any such limit. We do not believe that a 'one size fits all' rule would be appropriate. Any number which is specified could be too great or too small depending on the companies concerned. (We assume that your question was addressing directorships of independent listed companies, as clearly directors of a listed company may also serve on the boards of subsidiaries of that company and on the boards of companies that are not listed.)

In the UK our Corporate Governance Code lays down as a principle that all directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. There are specific provisions dealing with the positions of the chairman and non-executive directors aimed at ensuring that they will have the necessary available time to fulfil their roles effectively. Furthermore the Walker Recommendations include guidance on the time commitments to be expected from FTSE 100 BOFI NEDs and Chairmen and the FSA propose to include the time commitment required of a director in the factors which they consider in their 'fit and proper' test for BOFIs.

We think that it makes sense for supervisory authorities to adopt such an approach in relation to certain financial institutions but, as we state above, we do not believe that a specific limit on the number of directorships would be sensible or effective.

1.2 Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?

We think that, as a general corporate governance matter, it is desirable for the two functions to be kept separate and this approach is reflected in the UK Corporate Governance Code. In relation to financial institutions, we should think that it should be left to supervisory authorities to determine with each particular institution whether the constitution of the board presents any corporate governance issues and that this approach is likely to be more flexible and achieve better results than a blanket prohibition.

1.3 Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?

We do not believe that further legislation at the EU level is required or could be effective. However we would be in favour of issuers being encouraged e.g. by a corporate governance code (as they currently are by the UK Corporate Governance Code) to specify the duties and profiles of directors and have regard to the diversity of the board. Furthermore supervisory authorities should certainly have regard to whether the directors of financial institutions have adequate skills.

1.4 Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

We believe that the search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender (as recommended by the UK Corporate Governance Code). We are, though, strongly of the view that this is not something to be dealt with by legislative measures.

1.5 Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

The UK Corporate Governance Code has recently introduced a recommendation for the evaluations of boards of companies in the FTSE 350 to be externally facilitated every three years. The Walker Recommendations propose that the review should have external facilitation every second or third year and that an evaluation statement should be published in the annual report in the Chairman's Statement or separately.

The responsibility will remain with the boards to carry out their own reviews and the external bodies will assist with the evaluation process and we believe that this is the right approach. In addition we are of the opinion that the cost of such facilitation and the limited number of people who are qualified to provide such services makes such external facilitation inappropriate for smaller listed companies.

We do not think that it would be sensible to legislate for a requirement for external facilitation but we can see that supervisory authorities should be empowered to require this for particular companies.

We do not think that the evaluations themselves should be required to be made available to shareholders, as that might prove counter-productive in that the reports may in consequence be less direct and specific but there could be some high level reporting to confirm whether evaluations have taken place and whether any action is to be taken following the evaluation. We believe that the supervisory authorities should and would have access to them as part of their supervisory process.

1.6 Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

In the UK the Walker Recommendations propose the establishing of a board risk committee separately from the audit committee. The board risk committee would have responsibility for oversight and advice to the board on the current risk exposures and future risk strategy. The FSA propose to implement this recommendation in their High-level Systems and Controls Sourcebook (SYSC).

We think that it is sensible for FTSE 100-listed banks and insurers to consider the value of establishing such a committee. However we do not think that it is appropriate to impose a mandatory legal requirement in this regard. If the scale and complexity of the BOFI is such that the full board can adequately manage responsibility for risk, then there is no good reason why it should be legally obliged to appoint such a committee. In addition, there is no justification for requiring small firms or independent financial advisers to have a risk committee. We suggest that, at the EU level, there should be a requirement for regulated financial institutions to explain to their supervisor how risk is addressed (e.g. at board level or by using a risk committee) on the basis that they will have to satisfy their regulator that what they do is adequate.

1.7 Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

It is advisable but should not be compulsory.

1.8 Should the chairman of the risk committee report to the general meeting?

It is appropriate for the annual report to shareholders to cover risk issues and for that to be the subject of debate at the annual meeting if shareholders so wish. We do not believe that this should be compulsory. Shareholders of traded companies already have the right to ask questions at shareholder meetings under the Shareholders Rights Directive.

1.9 What should be the role of the board of directors in a financial institution's risk profile and strategy?

The board of directors should be responsible for setting the institution's risk profile and strategy. We do not think that their precise role in this connection should be prescribed. It is for individual boards to determine what is appropriate in the context of their own companies.

1.10 Should a risk control declaration be put in place and published?

We think there are advantages in requiring a company to state what its approach is to risk strategy and the risk profile it wishes to adopt e.g. as part of its explanation of its business model in its annual report. However we would prefer to see this suggested by way of a corporate governance code, rather than a legislative requirement.

1.11 Should an approval procedure be established for the board of directors to approve new financial products?

This should be a matter for individual boards. We think there could be real practical difficulties in identifying what constitutes a new financial product. Also, while some are risky, others will not be and it is not sensible to require boards to approve all new products.

1.12 Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

It would seem entirely sensible that, if a material new issue arises for a financial institution since its last review by the supervisory authorities, then it should have to inform the relevant authority but there would need to be clarity as to the materiality level to be applied.

1.13 Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?

We would be concerned about imposing a duty of care to take account of the interests of depositors and other stakeholders as a matter of European law without a better understanding of the existing directors' duties under the laws of Member States and how such a duty would impact on this. In particular, it would be important to consider how such a duty should apply if, for example, there were a conflict between the interests of (i) depositors (ii) other stakeholders and (iii) those to whom the directors owe their duties at present.

It would be important for directors to be clear about their duties and to whom they are owed and how any conflicts are to be resolved in practice. An examination of existing legal regimes may show that the interests of depositors and stakeholders are already taken into account – as is the case in the UK.

2. **General question 2: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.**

Specific questions:

2.1 **How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?**

The CRO's status would be enhanced if the officer reported directly to the board or the risk committee. We would support their having equivalent status to the CFO.

2.2 **How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?**

The board or risk committee should establish the frequency and content of risk reports and supervising authorities should be able to review these. The CRO should also be responsible for reporting problems to the board or risk committee at other times when he thinks this would be appropriate.

2.3 **Should the chief risk officer be able to report directly to the board of directors, including the risk committee?**

Yes.

2.4 **Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?**

The green paper does not say how an organisation should judge whether its IT tools need to be upgraded or not. We would expect supervisory authorities to consider the information available to management and how timely it is, as part of their supervisory function.

2.5 **Should executives be required to approve a report on the adequacy of internal control systems**?

It is not clear whether the report on the adequacy of internal controls is intended to be a report by executives to the board or a report by the company to its shareholders or others. We would expect management to report to the board on this. If the proposal is for the report to be to shareholders or the regulator, this should come from the full board.

The UK Corporate Governance Code recommends boards to conduct, at least annually, a review of the effectiveness of the group's systems of internal controls and to report to shareholders that they have done so. The UK Financial Reporting Council has produced guidance for directors on the internal control requirements of the Code (known as the Turnbull guidance) which covers amongst other things how boards are to report on their group's risk management processes and systems of internal control. We do not think there should be a legislative requirement for boards to report on their internal control systems – but a corporate governance code requirement to make a statement about the adequacy of internal control systems along the lines recommended under the UK Turnbull guidance would be desirable.

3. General question 3: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

Specific questions:

3.1 Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

We would be in favour of strengthening co-operation between external auditors and supervisory authorities and suggest that this is best done at Member State level rather than by European legislation.

3.2 Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?

We think that it would be better to look at whether the requirement under Directive 2006/48/EC to alert competent authorities is enforced in practice, before considering a new or different duty.

3.3 Should external auditors' control be extended to risk-related financial information?

There are areas where it might be helpful for auditors to validate some information provided to supervisory authorities, but we think it is important for directors to remain responsible for information provided. We also believe that not all risk-related information is necessarily information where auditor validation would be appropriate.

4. General question 4: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.

Specific questions:

4.1 Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?

We think that it would be very difficult for a supervisory authority to check if a board is functioning effectively. However, we do think that supervisory authorities should be required to raise any question or concerns about board functions or risk management with the relevant board.

4.2 Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?

Please see our answer to 4.1 regarding the functioning of the board. Supervisory authorities should without doubt have the necessary powers to satisfy themselves that risk management is being properly addressed. In the UK, the FSA is vested with powers in this respect.

4.3 Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

We think it would be helpful to extend the eligibility criteria in this way. However, in order to maintain diversity on a board, we think that the supervisory authority should consider each individual in the context of the board as a whole, so that every director is not required to have exactly the same skills and attributes.

5. General question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?

Specific questions:

5.1 Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

We are not in favour of compulsory disclosure but would support an approach that encourages institutional shareholders to disclose their voting practices and policies.

5.2 Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

We would not support an obligation, but would support an approach to encourage adherence to a code – which we think could be a national code or an internationally recognised code.

5.3 Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'[1]?

We would support EU legislation to enable listed issuers to require shareholders to provide information about those interested in their shares. This should assist better dialogue. However, we are not convinced that this would make a difference to empty voting, which we think would need other measures. (Please see our comments on the empty voting issue in our response to the current review of the Transparency Directive.) We are not clear what measures should be taken to prevent empty voting or the justification for this, given that shareholders with an economic interest can vote as they wish and may be influenced by other interests. We think that it is difficult to justify making a significant distinction between a shareholder who votes when he has no financial interest in the shares and one who sells immediately after voting. It may be that if the disclosure obligations result in disclosure that a shareholder has no interest in a company, this is sufficient.

5.4 Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

We believe shareholders are sometimes inhibited in discussing their concerns with other shareholders because of their concern that they will be treated as acting-in-concert, which may have damaging consequences. We think it would be helpful for Member States to be asked to consider any provisions which may give rise to such concerns, with a view to removing them.

6. General question 6: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

Specific questions:

6.1 Is it necessary to increase the accountability of members of the board of directors?

No – we think this should be left to Member State law and to companies and shareholders to enforce.

6.2 Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

No. It would be inappropriate to try and harmonise at EU level in this area. We do not think it is necessary or appropriate to reinforce the civil or criminal liability of directors. There is no evidence that the financial crisis was caused or exacerbated by there being insufficient liabilities for defaults by directors. The green paper does not set out in detail which corporate governance

---

1 Vote by a shareholder with no corresponding financial interest in the company for which they are voting, with potentially negative consequences for the integrity of the corporate governance of listed companies and the markets on which their shares are traded.

principles it thinks management should be required to implement or the standards that would apply to determine if the principles are met or not.

7. General question 7: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.

Specific questions:

7.1 What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

We are not in favour of additional EU measures on remuneration for directors of listed companies. We would prefer to see better application of the current recommendations.

7.2 Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?

The green paper does not set out what the problems are that need to be addressed or provide evidence that these problems are widespread. We would not be in favour of prohibiting the grant of stock options – this would be too drastic. We are not in favour of regulation at EU level.

7.3 Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?

We do not think that there is evidence that such favourable tax treatment encourages excessive risk-taking. We are in favour of encouraging companies to ensure that the time period for realising the benefit of stock options is such as to encourage directors and employees to take a long term view.

7.4 Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

We think that shareholders should be encouraged to take an active role in establishing their company's remuneration policy and expressing their views on the policy put forward. We think that involving employees or their representatives would cause difficulties.

7.5 What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

We think that the requirements on golden parachutes and severance packages should be left to Member States.

General question 7a: Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?

Specific questions:

7.6 Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

No. Not all employees in such institutions were responsible for the problems that arose and such institutions need to be able to recruit new employees on a competitive basis.

8. General question 8: Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.

Specific questions:

8.1 What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?

-

8.2 Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?

The Committee is keen to point out that this would be a large and complex piece of work. From the UK perspective it would not be desirable to introduce another layer of rules on top of the (European Directive driven) FSA's conflicts rules due to the complexity of reconciling the existing substantial body of conflicts rules.

1 September 2010