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Inquiry into Corporate Governance in Systemically Important Financial Institutions

Written evidence from the Company Law Committee of the City of London Law Society

The City of London Law Society represents approximately 14,000 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. This submission has been prepared by the Company Law Committee.

The Treasury Select Committee's inquiry has a broad scope and includes some questions that go to the heart of corporate governance of UK companies. It is not within our remit to respond to the specific focus of the inquiry but we wish to draw the Committee's attention to the important distinction between the role and objectives of the company law framework that regulates the governance of UK companies generally and the role and objectives of the regulatory framework that governs financial institutions.

We believe that this distinction is important. It is right that financial institutions should be subject to special rules because of the systemic risks to which they expose the wider community. But we do not think it is appropriate to modify the corporate governance framework that applies to companies generally and which is designed to ensure that all companies, including financial institutions, are run in a way that promotes their success for the benefit of their shareholders. Altering this core statutory obligation of directors in relation to systemically important financial companies will create unhelpful confusion of responsibilities. If it is right that special considerations apply to systemically important financial institutions, we suggest any additional constraints should be imposed as part of the regulatory regime (enforced by a regulator with a close supervisory relationship with the companies concerned) and not by changes to the governance framework.

The two specific questions in the terms of reference on which our concerns are focussed are Question 2 *(Are board structures effective?)*, Question 3 *(Is more intrusive regulation a substitute or complement to effective corporate governance? Is a "comply or explain" approach an effective framework for governance?)* and Question 8 *(Should non-executive directors bear greater liabilities than under current law?)*.

Question 2

Are board structures effective? For example, should UK financial institutions consider adopting alternatives to the unitary board structure?

The UK corporate governance framework allows considerable flexibility in the way companies organise their boards. Among public companies this ranges from boards that are broadly balanced between non-executive and executive directors to those that are preponderantly non-executive with one or two executives. Each approach has its proponents and companies are free to decide, after appropriate engagement with their shareholders, which will be most effective for them. The question seems to suggest that the Treasury Select Committee may want to go further and consider whether a dual board structure would be appropriate for SIFIs. That would be a step that would require a major re-engineering of the governance framework for those institutions, including defining the duties and responsibilities of each board. No doubt in considering this question the Treasury Select Committee will seek evidence of how other governance systems work and whether they proved more effective in the recent financial crisis compared to unitary boards; and in assessing that evidence we would urge the Treasury Select Committee to recognise that any corporate governance framework is a complex system of checks and balances: the perceived effectiveness of dual board structures within a different legal and cultural framework would not necessarily be replicated in the UK.

Question 3

Is more intrusive regulation a substitute or complement to effective corporate governance? Is a "comply or explain" approach an effective framework for governance?

We do not believe more intrusive regulation should be a substitute for, or a complement to, effective corporate governance. The "comply or explain" approach to corporate governance is applied against a regulatory background that sets certain minimum standards. The comply or explain approach allows companies to preserve operational flexibility and to work out their own optimal arrangements in dialogue with their investors. This gives flexibility where a standard imposes a particular burden on smaller companies or, for some reason (which may be temporary) is thought not to be appropriate for a particular company. Regulations, which are slow to adapt, are invariably crafted in order to achieve a political consensus. We believe regulations are likely to result in lower standards being set than a "comply or explain" approach which can set higher aspirational standards (because companies can choose to explain if they do not comply) and can evolve more quickly than regulations in the light of changing conditions and investor expectations. By way of example, the UK Corporate Governance Code not only expresses broad principles, but also includes a number of concrete guidelines. Recent work by the Financial Reporting Council demonstrates that when new higher standards of corporate governance have been introduced companies have been relatively quick to adopt the new standards (for example in relation to putting all directors up for annual election) even though initially there was not consensus about the new requirement. The FRC has also shown that there is high compliance with the Code and generally the quality of explanations is good and that companies and investors are working together to enhance the quality of disclosure in other cases of non-compliance. More intrusive regulation could make companies less willing to strive to meet the higher standards that emerge under a "comply or explain" approach and would also impose a greater burden on smaller companies less able to meet the higher standards at an early stage (or where the higher standards may not be appropriate for their particular situation). There is a risk that more intrusive regulation could result in an approach that involves more box-ticking and boilerplate disclosure: a race to the bottom, rather than encouraging companies to engage with investors and the benefits of adopting the Code provisions.

While there is certainly a role for regulation in constraining corporate behaviour that could increase systemic risk and harm the wider public (e.g. regulation requiring banks to hold minimum levels of capital having regard to their risk-weighted assets; regulation protecting the environment), more intrusive regulation of a company's governance arrangements would shift responsibility from companies and their owners to the regulator, undermining the role of shareholders as responsible owners and create a confusion of responsibilities on the part of the directors.

Question 8

Should non-executive directors bear greater liabilities than under current law?

We do not understand why the question focuses on non-executive directors. If it is concerned with general legal duties (rather than specific regulatory obligations) we think the distinction is misconceived. We do not believe that imposing additional liabilities on directors will achieve any desired improvement in the stewardship of their companies. The standards of conduct and assurance required by the Companies Act are high. More onerous standards would expose directors to liability without fault which we do not believe can be justified. It would add a very real and substantial disincentive for individuals to accept appointment to boards and if, as we suggest is the case, good governance is as much about having the right people as the design of the legal framework, this proposal would be counter- productive.

We hope these comments are helpful to the Committee. Please contact William Underhill (william.underhill@slaughterandmay.com), the Chairman of the Company Law Committee, to discuss any aspects of this memorandum.

30 May 2012