



EC green paper on corporate governance in financial institutions

The European Commission has published a green paper on a range of options to strengthen corporate governance in EU financial institutions. Some of the green paper's proposals follow UK best practice, but in other respects it goes much further.

This briefing outlines the main points raised. Interested parties wishing to comment on the paper should do so by 1 September 2010.

The European Commission (EC) has published a green paper, *Corporate governance in financial institutions*, inviting views by 1 September 2010 on a range of options to strengthen corporate governance in EU financial institutions (http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf).

Many of the green paper's options have already been examined from a UK perspective over the past year – in particular by Sir David Walker's *Review of corporate governance in UK banks and other financial industry entities*, the Financial Reporting Council's (FRC) consultation on the new UK Corporate Governance Code (the Code, applicable to all listed companies for financial years starting on 29 June 2010 or later) and the Financial Services Authority's (FSA) January 2010 consultation paper on effective corporate governance. Some of the green paper's proposals follow UK best practice, but in other respects it goes much further. For example, it invites views on remuneration for directors of listed companies, including whether stock options and golden parachutes should be prohibited, asks if the civil and criminal liabilities of directors need to be reinforced and asks if shareholder control of financial institutions is still realistic. It also asks about imposing a new duty of care on directors of financial institutions to take account of depositors' and other stakeholders' interests.

The green paper has been published with an EC staff working paper, *Corporate governance in financial institutions: the lessons to be learnt from the current financial crisis and possible steps forward* (http://ec.europa.eu/internal_market/company/docs/modern/sec2010_669_en.pdf).

EC's key options for reform

Introduction

The green paper focuses on:

- the functioning, composition and skills of boards of directors;
- strengthening risk management-related functions;
- expanding the role of external auditors;
- strengthening the role of supervisory authorities in the governance of financial institutions; and
- the place and role of shareholders.

The EC emphasises that it does not propose a 'one size fits all' approach. The rules could vary according to the legal form, size, nature and complexity of the financial institution and existing legal and economic models.

The EC has harsh views of financial institutions' boards of directors and some types of shareholders (responsible in its view for encouraging excessive risk taking). It concludes that questions have been raised about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders. These criticisms colour many of the questions that follow.

Board of directors

Time commitment

The green paper asks for views on whether the number of boards on which a director may sit should be limited, suggesting a cap of three.

Combining chairman and CEO role

The green paper questions whether combining the functions of chairman of the board and chief operating officer should be prohibited in financial institutions.

Skills and diversity

The green paper asks whether recruitment policies should specify the duties and profile of directors and the chairman, ensure directors have adequate skills and ensure diversity in board composition (in particular, encouraging more women and 'individuals with different backgrounds' to join boards).

Board evaluation

The green paper asks about compulsory evaluation of the board by an external evaluator, with the result made available to supervisory authorities and shareholders.

Duty of care

The green paper asks about imposing a duty on the board to take account of depositors' and other stakeholders' interests when making decisions.

Conflicts of interest

The green paper argues that it is necessary to strengthen measures to prevent conflicts of interest to safeguard the objectivity and independence of judgement of board members.

Risk

Risk committee

As recommended by Walker for FTSE 100 bank or life insurance companies (but not required by the Code), the green paper raises the issue of mandatory board risk committees and rules on their composition and function.

Board's role in risk profile and strategy

The green paper also focuses on the board's role in risk management. Options put forward include:

- requiring the board to publish a 'risk control declaration' and to set up a procedure for the board to approve new financial products;
- requiring the board to inform supervisory authorities of any material risks it is aware of;
- enhancing the status of the chief risk officer (CRO) and providing a direct reporting line to the board;

- improving communication between the risk management function and the board; and
- requiring an executive report on the adequacy of internal control systems.

External auditors' role

The green paper also raises questions about the role of external auditors in corporate governance – in particular, should co-operation between external auditors and supervisory authorities be improved and, if so, how? Should they be under greater duties to inform the board and/or supervisory authorities if they discover 'serious matters' or 'substantial risks' when performing their duties (a 'duty of alert')? What role should they have in relation to risk-related financial information?

Supervisory authorities

The green paper invites views on the role of supervisory authorities in the internal governance of financial institutions. It asks whether authorities should have the power and/or duty to check the correct functioning of the board and the risk management function. It also questions whether and, if so, how directors' eligibility criteria, which now focus on whether a director is 'fit and proper', should be extended to his technical and professional skills and individual qualities – this is already part of the FSA's assessment in the UK.

Shareholders

Review

The EC says it plans to carry out a review to motivate shareholders to engage in dialogue with financial institutions and monitor senior management's decision making and consider the long-term viability of the financial institution.

Code of best practice

The green paper invites views on whether institutional investors should be obliged to adhere to a national or international code of best practice, giving the example of the International Corporate Governance Network (ICGN) Global Corporate Governance Principles. The role of institutional investors in improving corporate governance and risk management was one of the key elements of the Walker review and the outcome of the FRC's consultation on the Stewardship Code is expected shortly.

Disclosure of institutional investors' voting practices

The mandatory disclosure of institutional shareholders' voting policy and practices has been on the corporate governance agenda for several years in the UK and the EC raises this as an option in its green paper. It asks if disclosure should be compulsory and how often disclosure should be made. Some member states already place some disclosure obligations on shareholders and others have chosen to apply international standards – eg requiring institutional investors to report against the UN Principles for Responsible Investment.

Promoting shareholders' engagement

Various other issues on which the FRC has consulted in its Stewardship Code consultation are raised in the green paper. The EC has invited views on what measures could encourage shareholders to engage in corporate governance. It asks if disclosure of shareholders' identity should be facilitated to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'.

Effective implementation of corporate governance principles

The green paper also asks for views on the wider question of senior management's legal accountability for the correct implementation of corporate governance principles. In particular, it asks whether the civil and criminal liability of directors should be 'reinforced'. This suggests a potentially alarming departure from the normal 'comply or explain' approach to corporate governance taken in the UK, where non-compliance does not in itself generally incur any form of civil or criminal liability.

Directors' remuneration

In April 2009 the EC adopted two new recommendations to strengthen governance of directors' remuneration, proposing several principles for remuneration structures in order to better link remuneration to performance. The green paper notes that a large number of member states have yet to adopt any implementing measures and that where implementing steps have been taken there is too much diversity in the resulting rules, particularly on remuneration structure and severance packages.

The green paper puts forward various options for possible additional measures at EU level. These apply to

all listed companies, not only financial institutions. For example, it asks whether:

- directors' stock options should be regulated or prohibited;
- favourable tax treatment of stock options and other similar remuneration encourages excessive risk taking;
- shareholders, employees and their representatives should have a bigger role in establishing remuneration policy;
- severance packages ('golden parachutes') should be regulated or prohibited; and
- the variable component of remuneration in financial institutions that have received public funding should be reduced or suspended.

Conflicts of interest

The green paper asks about possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector. The EC observes that surveillance of conflicts of interest by the market is insufficient and asks whether legal requirements designed to prevent and manage conflicts of interest should be harmonised across the banking, securities and insurance sectors. The EC appears to have in mind that there is no real equivalent (at EU level) for banks and insurers to the detailed rules on conflicts of interest that apply to securities firms (and banks doing equivalent business) under the Markets in Financial Instruments Directive – although in the UK all authorised firms are subject to FSA principles and rules on conflicts of interest.

Next steps

Comments on the green paper

The paper invites interested parties' comments by 1 September 2010.

Broader corporate governance review

The EC has announced that it will launch a broader review on corporate governance within listed companies in general and, in particular, on the place and role of shareholders, the distribution of duties between shareholders and boards of directors with regard to supervising senior management teams, the composition of boards of directors and corporate social responsibility.

More information

- EC green paper on corporate governance in financial institutions: http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf.
- EC staff working document *Corporate governance in financial institutions: lessons to be drawn from the current financial crisis; best practices*: http://ec.europa.eu/internal_market/company/docs/modern/sec2010_669_en.pdf.
- EC Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies: http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf.
- EC Recommendation 2009/384/EC: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:120:0022:0027:EN:PDF>.
- Sir David Walker's recommendations (2009): http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/walker_review_information.htm.
- Our briefing on Sir David Walker's final recommendations, *Radically changing the corporate governance landscape?* (2009): www.freshfields.com/publications/pdfs/2009/nov09/27214.pdf.
- The FRC's UK Corporate Governance Code (2010): www.frc.org.uk/documents/pagemanager/CorporateGovernance/UK%20Corp%20Gov%20Code%20June%202010.pdf.
- The FSA's consultation paper *Effective corporate governance (significant influence controlled functions and the Walker review)* (CP 10/3 January 2010): www.fsa.gov.uk/pubs/cp/cp10_03.pdf.
- Our briefing on FSA consultation paper CP 10/3 *Effective corporate governance?* (2010): www.freshfields.com/publications/pdfs/2010/mar10/27694.pdf.
- The ICGN The Global Corporate Governance Principles: Revised (2009): www.icgn.org/files/icgn_main/pdfs/best_practice/global_principles/icgn_global_corporate_governance_principles_revised_2009.pdf.
- The Stewardship Code consultation (2010): www.frc.org.uk/corporate/investorgovernance.cfm.

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