



Effective corporate governance?

The Financial Services Authority (FSA) published a consultation paper on effective corporate governance earlier this year. The paper reinforces the FSA's renewed focus on the quality of firms' governance and sets out proposed changes to the approved persons regime, the FSA's expectations in relation to non-executive directors (NEDs) and implementing measures in support of Sir David Walker's recommendations. This briefing examines the key proposals and their likely impact for firms.

The Financial Services Authority (FSA) published a consultation paper on effective corporate governance on 28 January 2010. The paper reinforces the FSA's renewed focus on the quality of firms' governance and sets out proposed changes to the approved persons regime, the FSA's expectations in relation to non-executive directors (NEDs) and implementing measures in support of Sir David Walker's recommendations (see our briefing [Radically changing the corporate governance landscape?](#) November 2009). Comments on the consultation paper have been requested by 28 April 2010.

Introduction

The proposals contain a significant rule change requiring regulated holding company directors who exercise a significant influence function (SIF) over a regulated subsidiary to be separately approved in respect of the subsidiary. Otherwise, the Financial Services Authority (FSA) uses the consultation paper not to consult but rather to inform the regulated community of how it intends to use its powers and what is expected of firms and individuals in certain areas. One key issue explored is the FSA's recently introduced use of interviews for candidates carrying out a SIF. The information contained provides a useful overview of how an interview may be conducted and will be compulsory reading for any potential interviewee.

Changes to the definitions of SIFs

The FSA proposes to create nine new and more specific controlled functions to capture the key roles within firms. However, it is expected that all of these roles would currently fall within the scope of one of the governing controlled functions, ie director, NED, partner or systems and controls.

A new controlled function will be required for those individuals within the firm's holding company or parent entity who are likely to exert a significant influence over the regulated firm, although this would not apply if the parent entity is authorised within the European Economic Area (EEA). Since July 2009 these individuals have been categorised as either performing the director or non-executive role and the definitions of these functions will be correspondingly decreased in scope.

The role of the NED is proposed to be split into six functions, consisting of the existing NED role and five more detailed functions: chairman, senior independent director, chairman of the risk committee, chairman of the audit committee and chairman of the remuneration committee. Under this proposal, an individual acting as a chairman would be required to hold both the NED function and the new chairman function (CF2a) so that the FSA might identify and assess individuals against the competences it considers necessary to perform such roles.

The final proposal regarding significant influence functions is to reinstate the individual functions of finance, risk and internal audit rather than having the umbrella function of systems and controls. Further, it is proposed that if an individual performing a governing function also performs one of these functions, separate approval for the finance, risk or internal audit function would be required so that specific technical competences might be proved.

Transitional provisions would require firms to notify the FSA within three months on a specially-designed form detailing which current approved person was performing any of the new roles. New applicants would be required to apply for approval under the new controlled functions. Special rules extending the notification period to 12 months apply to smaller firms if an individual who performs a governing function also carries out one of the systems and controls functions.

Extension of the scope and application of the proposed parent entity SIF controlled function

The current exclusion applying to a parent entity of a UK regulated firm that is a limited liability partnership or a non-body corporate is proposed to be removed because corporate status is deemed irrelevant.

If a firm's parent entity was FSA-authorized, an exclusion existed. However, the FSA proposes to require separate approval for individuals within the parent entity who also carry out a SIF for the subsidiary. The FSA promises a 'streamlined transitional process' relying largely on the current assessment of fitness and propriety.

Extension of the significant management function to UK branches of EEA banks

Currently only individuals exercising the significant management function in respect of designated investment business are required to obtain approval. It is proposed to extend this requirement to individuals exercising this function in respect of retail banking activities of a UK branch of an EEA bank. This means they can be held accountable for activities in respect of which the FSA regulates retail banking conduct of business.

Clarification of the FSA's position on 'compromise agreements'

Guidance is proposed to clarify the FSA's view that its requirements override any duty of confidentiality entered into by a firm and its employee (or ex-employee) reached in a compromise agreement following that person's dismissal or resignation from an authorised firm.

Increased use of FSA interviews for a SIF role

This part of the consultation paper does not contain any consultation proposals but rather sets out information on the FSA's processes and what is expected of firms in this area. This is because under the Financial Services and Markets Act (FSMA) the FSA has always had the power to interview candidates for SIFs and plans to use this power more widely in the future.

The FSA is clear that it is (and remains) the regulated firm's responsibility to ensure a candidate is fit and proper for the role in question. As part of the application for approval, it expects a firm to provide sufficient information to satisfy the FSA that appropriate due diligence has been carried out and notes that 'regrettably' this has not always been the case in the past. Failure to do so can result in the FSA questioning the quality of a firm's systems and controls and could ultimately lead to supervisory action. Specific guidance is given regarding the type of information that will assist the FSA in its decision and the application form is to be amended during 2010 to remind firms to supply the appropriate information. If firms can demonstrate appropriate due diligence has been undertaken, this may negate the need for an interview.

It is suggested that a firm subject to close and continuous supervision engages with the FSA at the final shortlisting of candidates for a SIF role. If this is not observed, any public announcement of an appointment may need to include a caveat that it is subject to FSA approval.

In most cases, although the FSA retains a discretion to interview, candidates for a SIF role will be able to be assessed without it doing so. However, the FSA will actively consider the need to interview candidates for any of the following roles in larger, more complex or risky firms:

- chairman;
- chief executive;
- senior independent director;
- finance director;
- chief finance officer;
- risk director;
- chief risk officer; and
- NEDs whose responsibilities include chair of the audit, risk or remuneration committee.

The decision to interview does not imply any pre-existence of concerns about the application but is made depending upon the type and size of firm, the role, the candidate and any information provided to the FSA as part of the application. The purpose of the interview is to assess the competence and capability of the candidate. The other criteria of honesty, integrity and reputation and financial soundness are usually assessed by 'baseline' checks such as credit checks.

If an interview is requested, it will be planned and conducted by a panel made up of supervisors, technical specialists and other specialist support if required, eg an FSA senior advisor (the FSA announced the appointment of five such advisors including Sir Dominic Cadbury in November 2009). Candidates will not usually be accompanied to an interview, except in exceptional circumstances such as disability. This is so that the discussion can take place freely in respect of the candidate's understanding of the firm and its business model. Candidates will be assessed against certain core competences including:

- market knowledge;
- business strategy and model;
- risk management and control;
- financial analysis and controls;
- governance, oversight and controls; and
- regulatory framework and requirements.

In addition, the panel can observe non-technical skills and behaviours such as whether a candidate displays the appropriate authority to conduct the role effectively. If gaps are identified in skills - technical or otherwise - the FSA will look for evidence that the individual recognises and is capable and willing to address these shortcomings.

Following the interview the FSA may either grant an application, grant the application but with an action plan

to complete appropriate training and development or refuse the application. Appeals against such refusals are made to the Regulatory Transactions Committee (RTC), an internal committee that oversees when and how the FSA exercises its statutory powers. If the RTC agrees with the decision to refuse the application, a warning notice will be issued privately to the firm at which point it may either withdraw the application or make written or oral representations to the RTC and ultimately to the Financial Services and Markets Tribunal. Decisions made by either body may be published.

NEDs

Guidance on the role of NEDs is to be amended to incorporate the FSA's response to the Walker review. Firstly, guidance on the 'fit and proper' test will clarify that the FSA may look at the extent to which a NED is capable of meeting his or her new contractual time commitment (recommended by the Walker review) when assessing fitness and propriety for the role. Other roles and activities undertaken by a NED, including other NED positions, should be taken into account by a firm when considering suitability for a proposed role.

Secondly, the FSA proposes to delete current guidance that discusses the limits of NED liability to prevent misinterpretation of this guidance and ensure NEDs are aware that the FSA would hold them responsible if they did not meet the required standards. The FSA considers that NED responsibilities are broad and would include intervening and challenging the executive if appropriate.

Finally, the proposed guidance in CP08/25, which sought to clarify the FSA's expectations of NEDs, has been withdrawn because the FSA now believes this is adequately covered in the Walker review recommendations and in its own proposals.

Response to the Walker review

The FSA is 'keen to support' the delivery of Sir David Walker's recommendations. There are proposed consequential rule changes, although the majority of the recommendations require no rule changes but rather will be effected by the FSA aligning its supervisory practices with the Walker recommendations and by more intense regulatory scrutiny.

The major change to the FSA rules will be to implement the Walker recommendations with respect to the establishment of a board risk committee for FTSE 100 banks and insurance companies to be chaired by a chief risk officer. The FSA proposes to make the chair of this committee a specific controlled function.

Conclusion

The proposals to sub-classify the current governing functions and systems and controls functions for both NEDs and those executives from a firm's holding company or parent would permit the FSA to assess the individuals applying to carry out such roles against role-specific criteria. Combined with the increased use of candidate interviews, upon which valuable guidance is given in the consultation paper, this is designed to enable the FSA to assess more readily the fitness and propriety of executives and to hold them to account. It is unlikely that the current proposals are the last changes to be seen in this area given the increased emphasis placed on governance and accountability of senior management by the FSA.

For further information please contact

Michael Raffan
T +44 20 7832 7102
E michael.raffan@freshfields.com

Mark Kalderon
T +852 2913 2645
T +44 20 7832 7106
E mark.kalderon@freshfields.com

David Rouch
T +44 20 7832 7520
E david.rouch@freshfields.com

James Smethurst
T +44 20 7832 7478
E james.smethurst@freshfields.com

Melanie Fitzsimons
T +44 20 7716 4374
E melanie.fitzsimonst@freshfields.com

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