

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

On June 2, 2010, the European Commission (the “Commission”) published a Green Paper setting out suggestions to improve corporate governance in financial institutions¹ and remuneration policies in the financial sector (the “Green Paper”).² The Green Paper solicits the views of interested parties on these suggestions and asks for indications of any further measures deemed necessary to address perceived corporate governance deficiencies. The Green Paper is intended to be presented at the G20 Toronto summit in late June 2010.

By way of background, on March 20, 2009, the European Council endorsed an expanded role for the EU in the regulation of the European financial system, as laid out in the report of the de Larosière Group published on February 25, 2009 (the “de Larosière Report”) and a Commission Communication published on March 4, 2009, which outlined a wide-ranging reform program for the financial sector for 2009/2010 (the “2009 Program”), including corporate governance in financial institutions.³ The Green Paper is the first step towards a reform of corporate governance mechanisms in the financial sector.

With regards to remuneration policies, the Commission has already taken several measures. On April 30, 2009, the Commission published a Recommendation on remuneration policies in the financial services sector⁴ and a Recommendation on

¹ Although the Green Paper covers all regulated financial institutions, its main focus is on large financial institutions, in particular banks and life insurance companies.

² http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf

³ Please see the CGS&H Alert Memorandum “Expanding EU Role in European Financial Regulation”, March 27, 2009 for further details, available at <http://www.cgsh.com/files/News/65500e4b-385a-4e7f-ae4-463d41e5b19d/Presentation/NewsAttachment/bdd54dfe-aea-4ba4-a3c3-48237c545ed6/CGSH%20Alert%20-%20New%20EU%20Financial%20Regulatory%20Framework.pdf>.

⁴ http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf; please see also the CGS&H Alert Memorandum “EU Initiatives Regarding Remuneration Policies for the Financial Services Sector” available at http://www.cgsh.com/cgsh/EU_Initiatives_Regarding_Remuneration_Policies_for_the_Financial_Services_Sector.pdf.

directors' remuneration (the "2009 Remuneration Recommendations").⁵ In addition to the 2009 Remuneration Recommendations, legislative proposals are currently being discussed to reform remuneration in the banking, asset management and insurance areas.⁶

This memorandum briefly reviews the Commission's consultation regarding proposed solutions to address deficiencies and weaknesses in corporate governance within financial institutions and in the application of the 2009 Remuneration Recommendations, and briefly compares the proposed solutions to the initiatives taken by the United Kingdom Government and the Financial Services Authority (the "FSA").

I. COMMISSION CONSULTATION: OPTIONS TO ADDRESS DEFICIENCIES AND WEAKNESSES IN CORPORATE GOVERNANCE WITHIN FINANCIAL INSTITUTIONS

This public consultation highlights the Commission's belief that existing corporate governance practices within financial institutions need to be improved. To this end, the Commission is exploring different ways of enhancing 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 increasing the motivation of shareholders to show an active interest in the long-term governance of the institutions in which they invest.

⁵ http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf.

⁶ Legislative proposals are currently being discussed to reform remuneration in the banking and asset management sectors (by way of amendment to the Capital Requirements Directive (CRD) (2006/48/EC and 2006/49/EC) and the proposed Alternative Investment Fund Managers Directive (AIFM), respectively). The Commission proposes to apply the same approach to the insurance sector (in relation to implementation of the Solvency II Directive (2009/138/EC)) by the end of 2010, and to undertakings for collective investment in transferable securities (UCITS) in early 2011. The CRD is available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf and http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en02010255.pdf. The Committee of European Banking Supervisors (the "CEBS") has also been taking initiatives in relation to remuneration policies and on June 11, 2010, the CEBS published a report on the national implementation of its high level principles for remuneration policies (the "Report"), see <http://www.c-ebs.org/documents/Publications/Other-Publications/Others/2010/ImplementationReportHLPR.aspx>. The Report concludes that although considerable progress has made (such as improvements in remuneration committees and deferral schemes for bonuses), there are differences in the requirements set by supervisors and the measures adopted by financial institutions, and insufficient progress has been made to reflect material risks in remuneration. CEBS plans publish its final guidelines before the implementation of CRD 3, which is currently scheduled for January 1, 2011, following a consultation later this year.

The main suggestions put forward for consideration by interested parties are as follows:

A. RECRUITMENT, QUALIFICATIONS AND RESPONSIBILITIES OF DIRECTORS

In order to ensure that directors devote sufficient time and resources to the fulfillment of their duties, and have the requisite skills to do so effectively, the Commission has suggested that interested parties consider whether:

- recruitment policies should precisely identify the skill requirements for directors with the aim of increasing objectivity and independence of each member’s judgment;
- greater diversity of board members in terms of gender, cultural and educational backgrounds could improve their functioning and efficiency;
- the number of boards on which a director may sit should be limited, for instance to three, to ensure that they have sufficient time to carry out their duties;
- combining the functions of the Chairman and of the Chief Executive Officer should be prohibited in order to ensure that the roles are clearly defined and conflicts of interest are prevented;
- a procedure for evaluating the board’s performance by an external evaluator should be formalized and whether the results of the evaluation should be made available to supervisory authorities and shareholders;
- the accountability of directors for the correct implementation of good corporate governance principles should be increased; and
- the failure to implement, or to comply with, good corporate governance principles should give rise to civil and criminal liability of directors, bearing in mind that the competence for matters of criminal law lies with the Member States.

B. RISK MANAGEMENT, SUPERVISORY AUTHORITIES AND EXTERNAL AUDITORS

With a view to granting more authority to those in risk-management functions and redefining and strengthening the role of national supervisory authorities in the internal governance of financial institutions, the Commission has asked interested parties to consider whether:

- a specialized “risk committee” should be mandated within the board of directors which, in order to enhance the board’s role in risk supervision, would have to publish the board of directors’ approval of the risk strategy and profile of the financial institution (the “risk control declaration”);

- the authority of the risk-management function should be strengthened, potentially giving a Chief Risk Officer equal standing to the Chief Financial Officer;
- the communication system between the risk-management function and the board of directors should be improved;
- the role of supervisory authorities in the internal governance of financial institutions should be strengthened generally and whether they should be given the power and duty to allow them to check the effectiveness of the board and inspect the risk-management functions;
- supervisory authorities should extend the eligibility criteria (the “fit and proper test”) of directors to include technical and professional skills as well as individual qualities;
- boards of directors should be obligated to inform the supervisory authorities of any material risk they are aware of;
- boards of directors should be obligated to take into account the interests of depositors and other stakeholders (the “duty of care”); and
- there should be a stricter duty for external auditors to flag to the board of directors and the supervisory authorities anything serious discovered in the performance of their duties, and whether an audit or similar control function should be extended to the risk-management systems of financial institutions.

In addition, the Commission stresses the need for improved cooperation between supervisory authorities on the corporate governance of cross-border financial institutions.

C. RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS

The Commission points out that the widespread disinterest of shareholders in corporate governance puts into question the effectiveness of corporate governance rules based on the presumption of effective control by shareholders. Since this issue affects listed companies in general and not only financial institutions, the Commission is planning a broad review of the situation. In the meantime, in order to motivate shareholders to engage in a dialogue with financial institutions in which they invest, ensure that shareholders effectively monitor and supervise senior management’s decision-making and discourage excessive risk-taking to support the long-term viability of the financial institution, the Commission has asked interested parties to consider whether:

- institutional investors should be required to publish their voting and investment practices at shareholders’ meetings;

- institutional investors should be obliged to adhere to ‘stewardship codes’ of best practice, taking measures to avoid conflicts of interest and using their voting rights in a responsible way; and
- the identification of shareholders should be facilitated in order to encourage dialogue between companies and their shareholders.

II. COMMISSION CONSULTATION: CONSIDERATIONS FOR A MORE RIGOROUS AND CONSISTENT IMPLEMENTATION OF THE COMMISSION'S PRINCIPLES ON SOUND REMUNERATION IN THE FINANCIAL SECTOR AND WITHIN LISTED COMPANIES IN GENERAL

On June 2, 2010, the Commission published reports on the 2009 Remuneration Recommendations (the “Reports”).⁷

Under the Remuneration Recommendation for the financial services sector, Member States were invited to ensure that financial institutions have remuneration policies for risk-taking staff that promote sound and effective risk management. The Remuneration Recommendation set out guidelines on the structure of pay, on the process of design and implementation of remuneration policies and on the role of supervisory authorities in their review. The evaluation report concludes that only 16 Member States – Belgium, Bulgaria, Cyprus, France, Germany, Hungary, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Romania, Spain, Sweden and the United Kingdom – have taken measures to fully or partially promote the application of the Recommendation at the national level. The remaining 11 have not yet adopted any national measures, but the Czech Republic, Denmark, Estonia, Finland, Ireland and Portugal have indicated that they are in the process of doing so.

The Remuneration Recommendation for directors of listed companies (which also applies to directors of listed financial institutions) sets out best practices for the design of an appropriate remuneration policy for directors, focusing on certain aspects of the structure and determination of their remuneration, including shareholder supervision. The evaluation report concludes that 10 Member States – Austria, Belgium, Denmark, Germany, Italy, Lithuania, the Netherlands, Portugal, Slovenia, and the United Kingdom – have implemented at least half of the recommendations. However, most recommendations have been implemented only by a minority of Member States.

⁷

http://ec.europa.eu/internal_market/company/docs/directors-remun/com-2010-286-2_en.pdf and http://ec.europa.eu/internal_market/company/docs/directors-remun/com-2010-285-2_en.pdf.

Based on the Reports, the Commission has asked interested parties to consider whether:

- additional, potentially binding, measures are necessary at the EU level regarding directors' remuneration generally (the 2009 Remuneration Recommendations contain detailed guidelines the scope of which goes beyond the existing legislative proposals for the financial services sector);
- the granting of stock options and severance packages (“golden parachutes”) should be regulated or even prohibited;
- the favorable tax treatment of stock options and other similar remuneration should be reviewed because it may encourage excessive risk-taking; and
- the variable component of remuneration in financial institutions which have received public funding should be regulated or suspended.

III. CORPORATE GOVERNANCE AND REMUNERATION IN THE UNITED KINGDOM

The Commission is not alone in highlighting the ways in which existing corporate governance arrangements have failed to provide an effective check on risk management. In the United Kingdom, the Government and the FSA have been responsible for a number of initiatives to strengthen corporate governance in financial services institutions. Following the publication of the Walker Review in November 2009,⁸ the FSA put forward a number of proposals in relation to corporate governance that include recommendations as to board size, composition and qualifications, the role of institutional shareholders, governance of risk and remuneration. Many of the Commission's proposals are in keeping with the Walker Report's recommendations as implemented by the Financial Reporting Council and FSA through its review of the UK Combined Code.

IV. NEXT STEPS

The public consultation process will be open for responses until September 1, 2010, following which the Commission will decide on the nature and scope of any legislative and non-legislative measures to be implemented to address existing short-falls

⁸ See http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf. For a review of the Walker Report and corporate governance initiatives in the United Kingdom, please see CGS&H Alert Memorandum “Walker Review of Corporate Governance in UK Banks and Other Financial Institutions”, December 7, 2009, for further details, available at <http://www.cgsh.com/files/News/7d30a90e-2a83-4fff-981a-545e15a50ca0/Presentation/NewsAttachment/91d551dd-cba2-4405-93f6-56ab0288faa2/CGSH%20Alert%20-%20Walker%20Review%20of%20corporate%20governance%20in%20UK%20banks%20and%20Other%20financial%20institutions.pdf>.

in corporate governance and remuneration policies. The Commission does not expect to see such implementation until 2011.

In relation to remuneration policies, measures adopted in response to the consultation set out in the Green Paper would go beyond what the Commission has already committed and in part already proposed to come up with for all sectors of the financial services industry.

* * *

For additional information, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under banking and finance in the "Practices" section of our website (www.clearygottlieb.com) if you have any questions.

For additional information on issues regarding the financial crisis, please visit Cleary Gottlieb's Financial Crisis Resource Center at:
http://www.cgsh.com/financial_crisis_resource_center/eu_resources/.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS

12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

MOSCOW

Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE

Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME

Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN

Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING

Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax