CLEARY GOTTLIEB Alert Memo

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Walker Review of corporate governance in UK banks and other financial institutions

On July 16, 2009, HM Treasury published an independent review (the "Review") of corporate governance in UK banks and other financial institutions ("BOFIs"), conducted by Sir David Walker at the request of the Prime Minister, Gordon Brown[1]. The Review examines five key areas and makes 39 recommendations (the "Recommendations"). Since the remit of the Review was limited to the governance practices of BOFIs, the extent to which the Recommendations will eventually be extended to all UK listed entities remains to be seen.

I. THE RECOMMENDATIONS

The key Recommendations are summarised below by reference to the five key areas examined by the Review. Except in the few cases where responsibility for the Recommendation rests with the FSA, the Review envisages that most of the Recommendations will be incorporated by the Financial Reporting Council (the "FRC") into the Combined Code on Corporate Governance (the "Combined Code")[2]. The extent to which the FRC will amend the Combined Code is yet to be finalised; this is only likely to be decided after conclusion of the consultation phase. The FRC is currently reviewing the Combined Code and is expected to issue a progress report (which is expected to address the Recommendations) by the end of July 2009. We will be monitoring this progress report and its proposals in relation to the Recommendations. There are currently no proposals for new primary legislation to implement the Recommendations.

1. Board size, composition and qualification

The Review focuses on the actions of BOFI boards, rather than their size or organisation. In respect of BOFI boards, the Review recommends that non-executive directors ("NEDs") should have a minimum time commitment of 30 to 36 days a year clearly indicated in their letters of appointment, which is up to 50 per cent. more than the

1 Available at: http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf

2 Under the Listing Rules, the Combined Code applies on a "comply or explain" basis to all companies incorporated in the United Kingdom with a listing on the official list of the UK Listing Authority. Companies incorporated outside the United Kingdom that have a primary listing are simply required to disclose whether or not they comply with the corporate governance regime of their country of incorporation and the significant ways in which their corporate governance practices differ from those set out in the Combined Code.

current average of 20 to 25 days. The Review also stressed the need for BOFI NEDs to have financial industry experience and increased education and support, in order to enable them to engage pro-actively in board deliberation, above all on risk strategy. In a move that will surprise some corporate governance experts, the Review also expressed the view that the prohibition on CEOs stepping up to the chairman's role could be lifted.

Above all, the Recommendations in this area focus on the need to ensure that there is a knowledgeable and competent group of independent NEDs capable of questioning and challenging the decisions of the executives – Sir David has said that "alongside the necessity for financial expertise, non-executives, particularly chairmen, must be strong characters", adding that "financial expertise is meaningless without an atmosphere of challenge". The Review stresses that "independence of mind ", together with relevant industry experience, is more likely to be able to bring effective and constructive challenge to the board's deliberation process than the formal appearance of independence, and that BOFI boards should be permitted flexibility in departing from compliance with the Combined Code where this is felt to be justified in achieving the desired balance between financial industry expertise and independence.

2. Functioning of the board and evaluation of performance

The Review recommends that the chairman of a BOFI board should combine experience with a proven record of successful leadership in a significant board position, with particular weight being given to the latter, since "financial industry experience without established leadership skills is unlikely to suffice". The chairman should be expected to spend not less than two-thirds of his time on the chairmanship role, with the clear understanding that this role would take priority over any other business commitments in the event of need. Sir David has explained that this will mean BOFI chairmen cannot chair other companies. The chairman should also be proposed for election annually.

In keeping with the theme of "challenge", the Review recommends that NEDs should be ready and encouraged to challenge and test the executive board's strategy proposals and the board should be required to evaluate its performance every two to three years, with the assistance of external advisers, and to include this evaluation in the annual report.

3. The role of institutional shareholders: communication and engagement

The Review recommends that institutional shareholders should take a more active role in their portfolio companies and that the FRC's remit should be extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. The Review provides that the extended remit of the FRC should be clarified by separating the Combined Code into a "Corporate Governance Code" and a "Principles for Stewardship", and the FSA should encourage institutions that are authorised to manage assets for others to commit to the Principles for Stewardship on a "comply or explain" basis. The Review also recommends the publication of the voting records of fund managers and other institutional investors.

4. Governance of risk

The Review recommends the creation of board risk committees, separate from audit committees, to oversee and advise BOFI boards on current risk exposure and future risk strategy. The board risk committee (or board) risk report should be included in the annual report and accounts. Another Recommendation in this area is that BOFI boards should have an independent chief risk officer (the "CRO"), who should participate in risk management at the highest level on an enterprise-wide basis. The CRO should report to the board risk committee, with direct access to the chairman of the committee, if needed. The Review recommends that the board risk committee should perform due diligence before the board decides whether to proceed with proposed strategic transactions involving an acquisition or disposal.

5. Remuneration

The Recommendations set out in the final section of the Review are likely to be the most controversial. Sir David, in a statement, has said that the proposals on remuneration are "as tough, or tougher, than anything to be found anywhere else in the world". Although the Review stops short of proposing that levels of remuneration should be capped, the Recommendations include:

(i) Remuneration committees should scrutinise the pay of any executive who earns more than the average executive board member (a "High Earner");

(ii) The remuneration committee report should disclose, in bands, the number of High Earners and, within each band, the main elements of salary, bonus, long-term award and pension contribution;

(iii) Executive board members and High Earners should have their remuneration spread over five years, with half of their variable remuneration in the form of a long-term incentive scheme with vesting subject to a performance condition – half should vest after not less than three years and the remainder after five years – and short-term bonuses should be paid over three years, with not more than a third in the first year;

(iv) The remuneration committee report should disclose whether any executive board member or senior executive has the right to receive enhanced pension benefits; and

(v) Remuneration committee chairmen should stand for re-election if the remuneration committee report attracts less than 75 per cent. investor support.

II. IMPACT ON NON-BOFI UK LISTED ENTITIES

The Review concludes that the "comply or explain" approach of the Combined Code (combined with tougher capital and liquidity requirements and a tougher regulatory stance from the FSA) remains "the surest route to better corporate governance practice in BOFIs". Although the Recommendations address only the governance of BOFIs, Sir David has made it clear that, in his opinion, the Recommendations should be applied to all UK listed entities. Commenting on the Review in a recent interview, Sir David has stated: "The risk elements are bank specific, but much of the rest of it could be applied to any other company. Why wouldn't the challenge element apply to … anyone else?"

Sir Christopher Hogg, the chairman of the FRC, has stated that the FRC will be considering to what extent the Recommendations are applicable to non-BOFI listed entities. When Sir Christopher commenced the consultation period in connection with the FRC's review, he was inundated with arguments against amending the Combined Code, particularly in relation to non-BOFIs. However, in commenting recently that "[the] credit crisis was the result of a massive failure of governance at every level", Sir Christopher hinted that his report will echo Sir David in calling for stronger chairmen, more qualified directors, tighter controls on pay and formal reports on risk management.

It remains to be seen to what extent the Recommendations will eventually apply to non-BOFI listed entites. This will depend on the extent to which the FRC decides to incorporate the Recommendations into the Combined Code and whether or not the amendments to the Combined Code are made applicable merely to BOFIs or to all companies that are required to comply with the Combined Code.

III. NEXT STEPS

Comments on the Review are due by October 1, 2009. The FRC's progress report on the Combined Code is expected to be published within the next few weeks, with the final report due by the end of 2009, by which time the final version of Sir David's report and its recommendations – which is due by the end of November 2009 – should have been published. The FSA will issue a paper this autumn (fall), outlining its proposed response to the final recommendations that may have implications for FSA procedures or the interaction between the FSA and regulated firms. We will prepare a further memorandum if any of these reports contain substantive changes.

If you would like to submit any comments on the Review, please feel free to contact us in the manner set out below, or to contact the Review secretariat's mailbox directly - feedback@walkerreview.org or telephone +44 207 066 0032.

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Please feel free to contact any of your regular contacts at the firm or any of our partners listed under United Kingdom in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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