

The FSA's Proposals on Reforming Corporate Governance: New Elite or Endangered Species?

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Introducing its Consultation Paper 10/3, *Effective Corporate Governance*, the FSA refers explicitly to the general "increase in the intensity of our supervision and the degree of intrusiveness in areas of high risk". The FSA goes on to say that "this strategic development applies equally to our oversight of corporate governance arrangements in firms as it does to other prudential concerns".

Indeed, the FSA has been enhancing its supervision of management within authorised firms since the end of 2008, and in July 2009 introduced changes to the 'significant influence' controlled functions which these current proposals would take further.

During this period the Walker Review also added its influential recommendations on corporate governance, especially as to the quality of the board's oversight of executive officers. Increased supervision and intrusiveness, and a focus on management quality, are therefore the continuing themes of the proposals contained in this latest consultation. The CP proposes:

- a more precise classification of controlled senior management functions;
- extending the scope of the controlled function for certain individuals in the parent companies of authorised firms and introducing a new controlled function requirement for branches of EEA banks who take retail deposits in the UK;
- greater expectations of non-executive directors (although little help by way of guidance);
- a response to the Walker proposals on risk oversight and shareholder engagement; and
- detailed guidance on the FSA's procedures for approving senior individuals, including interviews (amounting almost to an exam syllabus).

Given the FSA's stated concerns, some of the proposals – for example regarding the reclassification of controlled functions – are relatively uncontentious. Some – for example regarding the approval of significantly influential individuals at parent companies – face potential legal and practical challenges. Others – for example regarding the future role and responsibilities of non-executive directors (NEDs) – can be expected to provoke fierce debate.

New and re-classified controlled functions

The FSA considers that the scope of certain of the existing controlled functions, for which individuals require prior FSA approval, is now too broad. In particular, this applies to the scope of the 'governing functions' – the functions of acting as a director or NED for an authorised firm – and the 'systems and control function'. The FSA states:

"this means that we are currently unable to track and vet individuals who may change roles within one of those functions, even though the competences required for each role might be different".

It is proposed that these functions be broken down into more specific roles to bring greater clarity and, presumably, to enable the FSA to apply differing approval standards and, in due course perhaps, also ongoing

competence requirements to those differing roles. It is proposed that the new more specific controlled governing functions be:

- chairman
- chairman of risk committee
- chairman of audit committee
- chairman of remuneration committee
- senior independent director
- parent entity significant influence (SIF)

and that there be three new controlled systems and controls functions in place of the existing single generic function, as follows:

- finance function
- risk function
- internal audit function

The FSA proposes that where a director performs one of the new specific functions, he or she will need approval both for being a director and for undertaking the specific role. Further, any individual who is to perform one of the three new systems and controls functions must seek specific approval for that function regardless of whether he or she is also approved to perform any of the controlled governing functions.

If implemented, these changes will inevitably mean that firms, and boards appointing individuals to significant roles within firms, will need to give greater thought to matching the skills and competencies of individual candidates with the particular needs of their roles; and that is clearly the FSA's intention.

The FSA will not, however, insist that individuals who are already approved under the current system to perform the relevant roles apply for re-approval under the new, more particular regime. As a transitional measure, firms will instead have to notify the FSA which individuals are performing each relevant new controlled function. The FSA has noted that it does not expect this reclassification exercise to lead to an overall increase in the number of approved persons. In other words, the FSA considers that each of these new controlled functions represents merely a sub-set of the existing controlled functions.

Although the competence of individuals already performing controlled functions will not formally be re-assessed, the FSA will expect such individuals to be competent to the same standards as any new applicant for the same post.

The parent entity 'significant influence' controlled function

Parent entity SIF would be a new category of controlled function used specifically to identify any individual at the parent undertaking of an authorised firm who was brought within scope of the director and NED controlled governance functions in July 2009 because his or her "*decisions or actions are regularly taken into account by the governing body of the firm*".

Formal guidance included in the FSA's Supervision Manual gives several non-exhaustive examples of when these circumstances might arise, including directors or senior management of a parent undertaking who in practice perform executive director or NED-equivalent roles in respect of the authorised firm.

The FSA is now proposing to extend the scope of application of the parent entity SIF category in two ways:

- It is to apply regardless of the corporate form of the authorised firm (at present LLPs and non-corporate bodies are excluded); and
- It is to apply even where the parent undertaking itself is FSA-authorised because, although the individual concerned may be approved for a controlled function within the parent undertaking, it does not follow that such approval should automatically cover the role that he or she performs in relation to the subsidiary firm.

The FSA has acknowledged a legal limitation on its rule-making powers in this area¹. The relevant provisions of the Financial Services and Markets Act 2000 state that the FSA can only require approval of individuals performing controlled functions if they are to be performed "under an arrangement entered into" by the firm concerned. An "arrangement" means "*any kind of arrangement for the performance of a function of [the firm] which is entered into by [the firm] or any contractor of [the firm] with another person*".

The FSA states expressly in its proposed guidance that, absent such an arrangement, the FSA has no power to require approval of any parent entity individual who is in fact exercising a significant influence over an authorised firm. However, the FSA confidently expects that "*a firm that allows major decisions to be taken by a group decision-making body will do so on the basis of a formal delegation from the firm's governing body*". Such a delegation, it is suggested, will amount to the requisite "arrangement".

Will this in fact be the case? A subsidiary would not typically delegate powers or authority to its parent: decisions and influence flow naturally downwards from the parent and routinely set the parameters for the deliberations and decisions of the subsidiary's management without the latter formally conceding power. In theory, therefore, it would seem relatively easy for a parent undertaking manager to avoid this aspect of the new approval regime. In practice, though, firms can expect to be pressed hard by the FSA if it detects 'avoidance' of the new rules, and so most may ignore this technicality unless there is a compelling case for resisting approval.

UK branches of EEA retail deposit takers

For understandable reasons (most notably the collapse of the Icelandic banks and the resulting difficulties experienced by UK depositors and, latterly, the UK Government), the FSA wishes to increase the level of its supervision of the activities of UK branches of EEA banks which solicit UK retail deposits. It is therefore proposing that individuals who perform a significant management function in respect of retail deposit taking activities in such branches must seek prior FSA approval.

In making these proposals the FSA is mindful that it is constrained by the home-host state division of responsibilities in the European Banking Directive. Under that Directive, the "prudential supervision" of branches is a home state responsibility, as is the requirement to ensure "robust governance" of banks.

The Directive nevertheless permits a host state to impose requirements on branches passporting into its jurisdiction for the "general good" of the host state. General good requirements are broadly taken to be limited to requirements relating to conduct of business and not to the quality of management. It remains to be seen, therefore, whether the FSA can successfully implement its proposal in respect of passported UK branches, or

¹ This legal issue was highlighted in an earlier briefing paper published by Slaughter and May; *A critical commentary on PS09/14: The FSA's extension of the approved persons regime*, July 2009, searchable at www.slaughterandmay.com

whether some EEA banks (perhaps with the backing of their national supervisor) will resist the proposal on the grounds that it is contrary to the division of responsibilities dictated by the Directive.

The FSA is aware of the legal difficulties it may face but does not, in the CP, explain how these are to be navigated.

Non-executive directors

The FSA's proposals for NEDs amount to taking with one hand and giving with the other.

The FSA proposes to delete current guidance which states: *"Where a non-executive director is an approved person... his responsibility and therefore liability will be limited by the role that he undertakes. Provided that he has personally taken due care in his role, a non-executive director will not be held disciplinarily liable either for the failings of the firm or for those of individuals within the firm."*

The FSA is concerned that this passage gives a misleading impression as to the extent of a NED's responsibilities. In particular, the FSA wants to emphasise that (following the Walker Review) NEDs have a "pivotal" role to play in the supervision and challenging of a firm's executive: *"Where it appears to us that executives have persistently made poor decisions, we will look closely at NEDs' performance if we feel they have not intervened in a timely and sufficient way"*. It will not be a defence for a NED to point to his or her limited formal responsibilities when accused of a failure to intervene and challenge the executive.

This leaves the potential regulatory liability of NEDs vague and open-ended, and could possibly be a major deterrent for those considering the NED role. As an alternative it would surely be open to the FSA to retain the comfort of the existing guidance but to redraft it to emphasise the key role of "challenging the executive" which the FSA (and the Walker Review) believes should be shared and more actively pursued by all NEDs.

At the same time, the FSA has withdrawn from consideration what was seen as overly-prescriptive guidance on the general responsibilities of NEDs which had been proposed in its earlier consultation on the controlled functions regime, CP08/25. This guidance could have been read as insisting that each individual NED had overall responsibility for all major governance issues at his or her firm. In withdrawing this proposal, the FSA acknowledges that NED responsibilities will vary from firm to firm and according to the overall composition of a firm's non-executive board. The introduction of new, more detailed controlled governance functions is intended to meet some of its concerns around competencies and experience in this area.

The withdrawal of the previously proposed (and arguably unhelpful) guidance is to be welcomed; the introduction of new (also arguably unhelpful) guidance may not be. The result of the combined initiatives may well be that NEDs could be held to account against standards which are not clearly articulated and which may therefore be readily interpreted at the convenience of the FSA, with hindsight, in disciplinary proceedings. NEDs would be well-advised to review their directors' and officers' insurance cover in this context.

The Walker Review – supervision of risk and shareholder engagement

The Walker Review concluded that it was an essential role of a firm's governing body to monitor the management of risk. The Review recommended that, for firms of a certain size and complexity, it would be best practice to form a risk committee at board level to undertake this supervision and to appoint a Chief Risk Officer accountable to the governing body of the firm.

In CP10/3 the FSA has endorsed the Walker approach, and proposes new guidance to support it. The guidance specifically reflects a number of issues addressed in the Walker Review. In particular, it sets out that the Chief Risk Officer should be independent of the firm's business unit; have sufficient authority, stature and resources; and have unfettered access to any part of the firm capable of having a material impact on the firm's risk profile.

The proposed guidance also sets out a list of the responsibilities to be undertaken by a risk committee, central to which is "oversight and challenge" of the executive's management of risk, and states that the chairman of the risk committee should be a NED.

It is for each firm to decide whether such a structure is appropriate, but the FSA has said expressly that FTSE 100 banks and insurers should establish such arrangements.

In this latest consultation the FSA also welcomes the Walker Review's spotlight on the importance of communication and engagement between firms and their shareholders. The FSA supports the development of the Stewardship Code, now being taken forward under the sponsorship of the Financial Reporting Council. The FSA has said that it is considering making a rule requiring authorised firms to disclose publicly the extent to which they comply with the Stewardship Code, explaining where relevant their reasons for not doing so.

Critics of the Walker Review have pointed out that cooperation between major shareholders on points of corporate governance would raise legal concerns, both at a UK and European level. There is a question as to whether those shareholders would then be "acting in concert" for the purposes of shareholder disclosure and statutory controller approval requirements.

The FSA has not yet been able to provide robust and clear guidance on this point, and states now merely that it hopes to consult on making guidance to address this issue later in 2010. As a legal matter, the FSA is somewhat constrained by the terms of the Acquisitions Directive and the unhelpfully broad meaning given to the term "acting in concert" in existing CESR guidance, so it will be difficult now to find a clean solution without broader international cooperation on the issue. There are no signs that this would be forthcoming (or indeed that it would be viewed as a particular priority among European regulatory reformists).

A guide to the FSA's "intrusive" approach to approving and supervising

The longest chapter in CP10/3 is devoted not to consultation proposals, but to a detailed statement of the FSA's policy for approving persons who are to perform significant influence controlled functions. The FSA had earlier announced its approach in a "Dear CEO" letter sent to firms in October 2009. CP 10/3 builds on this earlier announcement.

Depending on one's perspective, the statement of policy may be considered either chilling or helpful – or perhaps both. The Financial Times reports that about 10% of applicants for approval have pulled out of the process after having submitted their applications since the FSA made major changes to its procedures at the end of 2008. The FSA's transparency about the process may now help firms and applicants be better prepared to face this more intensive approval regime.

The responsibilities of firms

The FSA's guidance commences by underlining that it has been and will remain the primary responsibility of the firm concerned to ensure that individuals proposed for significant influence functions are fit and proper for their roles. This responsibility translates into a need for a firm to conduct due diligence on its candidate and to provide to the FSA detailed information about the candidate and the process by which the firm came to regard him or her as suitable. (It is to be noted in this connection that the FSA is more commonly now asking firms to produce references from previous employers – not always easy to obtain in a sector where previous employers can be fierce competitors.)

To encourage firms to go about this process thoroughly, the FSA states that "where appropriate due diligence" can be demonstrated by a firm, this may remove the need for the FSA to interview a candidate. In urgent, sensitive or complex cases, the FSA may, at the request of a firm itself, carry out due diligence checks focussing on probity issues, using "information sources that the firm would not have access to (such as checks with overseas regulators)".

The "fit and proper" determination

The FSA assesses applicants against three criteria:

- honesty, integrity and reputation;
- competence and capability;
- financial soundness.

Traditionally, the FSA placed most emphasis on the first and third of these. They remain important, but the thrust of recent changes in the approval process is that the FSA is now paying far greater attention to competence and capability, assessed in respect of six areas:

- market knowledge
- awareness of the firm's business strategy and model
- awareness of risk management and control issues
- understanding of financial analysis and controls
- understanding and judgment of the firm's governance oversight and controls
- awareness of regulatory framework and requirements

The FSA acknowledges that it will not be appropriate to assess every candidate against every one of these criteria, recognising that to do so "would be disproportionate and excessively resource-intensive". Also, each candidate will be assessed in the context of the *overall strength* of the existing governing body, so that the FSA should be prepared to take account of how the governing body as a whole measures up to the above criteria in deciding what level of competence is to be expected of a particular candidate.

In addition, though, and following a recommendation of the Walker Review, the FSA is proposing to add to the competence and capability assessment an examination of whether the individual concerned will be able to devote sufficient time to his or her role and responsibilities, especially in the case of a major bank or insurance company. This is particularly important for NEDs. However, no absolute or indicative number of days are (for now) to be prescribed.

Draft guidance set out in the consultation states that the FSA is looking to firms carefully to determine the time commitment required when appointing an individual. This determination will be taken into account in the approval process.

The interview

Although any candidate for a significant influence controlled function may be called to an FSA interview, the FSA says that it will "actively consider" interviews of individuals proposed for the following roles in 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 Audit, Risk or Remuneration Committees.

The interview itself will be conducted by a panel (which will be independent of the firm's normal supervisors), supported if necessary by one of the FSA's Senior Advisors². As well as the competencies mentioned above, the interview may cover the candidate's motivation, and his or her capacity to perform the role adequately given other commitments. The interviewers will also be interested to hear from the candidate as to what due diligence he or she conducted in respect of the firm before accepting the position. A candidate will be interviewed on his own, without support from the firm.

Any refusal to approve a candidate will be communicated to the firm informally at first. At this point, the FSA suggests, it is usually the case that the firm and individual decide either to modify or withdraw the application.

Conclusions

Strengthening governance in the financial sector is clearly now a priority for regulators globally and with these latest proposals the FSA has shown that, once again, it intends to be among the first-movers in setting standards. The underlying aim of the FSA's reforms in this area, echoing some of the themes of the Walker Review, is undoubtedly to bring about a greater focus on relevant skills and expertise for the financial sector boardroom, as well as experience.

One cannot sensibly argue against the aspiration for a new elite of senior individuals who can better take charge of the UK's financial sector: there is now a broad consensus, among firms as much as regulators and politicians, that a more robust governance culture is required in light of the weaknesses exposed by the financial crisis.

But do these proposals strike the right balance? Will they ensure high quality management? There must unfortunately now be a risk that an overly-intrusive and prescriptive process for approving and supervising managerial candidates will simply deter capable individuals from taking up those positions within financial sector groups.

The aspect of these proposals which could prove most significant in the long term (and, unfortunately, potentially damaging to financial sector management) is the FSA's apparent determination to hold NEDs accountable for the failings of executive management, on the grounds of the NEDs' implied omission sufficiently to challenge executive decisions.

As indeed the CP itself acknowledges in respect of certain NED roles, perhaps only NEDs who are "highly authoritative... and capable of challenging the executive effectively" need now apply.

² At the end of 2009 the FSA appointed several individuals with high-level financial services industry experience as Senior Advisors to assist the FSA in its work on governance issues.