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Our ref

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Dear Sir David

The Walker Review – A review of corporate governance in UK banks and other financial institutions

We welcome the ongoing discussion on the issues raised in the consultative document "A review of corporate governance in UK banks and other financial institutions", published by HM Treasury on 16 July 2009 ("the report"), and the opportunity to be able to contribute to the debate.

As a leading international law firm, Herbert Smith LLP provides legal advice and support to a wide variety of financial institutions authorised to conduct regulated activities in the United Kingdom under the Financial Services and Markets Act 2000, registered in the UK and abroad, as well as to listed companies, directors of listed companies, investors in listed companies and advisers to listed companies. We therefore take a particular interest in issues surrounding corporate governance, and our comments reflect both our legal view of the issues and our experience in acting for the range of participants in the market. We have, of course, discussed the proposals in the report with clients and others, and our views take account of these discussions.

Our comments follow the order of the specific questions raised in the report. Where a particular recommendation is not addressed, it is because we have no particular comments to add on that specific point.

Introductory comments

We strongly endorse the view that the Combined Code remains fit for purpose and that the "comply or explain" approach, which has the advantage of flexibility and seeks to avoid a box-ticking approach to compliance, remains the most appropriate vehicle for better corporate governance

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principles for BOFIs generally. We also support the suggestion that BOFIs should be willing to provide appropriate explanations in certain circumstances, and institutional shareholders should be prepared to consider and, if appropriate, accept these explanations, rather than to default to compliance with the Code in all instances as a matter of course.

Although the report proposes main conclusions and recommendations, it does not seek to address how these should be implemented, and suggests that implementation will effectively be a matter for "decision" after conclusion of the consultation phase. We welcome the fact that the FSA has already indicated that there will be a 3 month consultation period for its proposals on "Improving Standards of Corporate Governance". We strongly urge that the proposals for implementation of all recommendations and conclusions made in the final version of the report to be published in November should be subject to the same careful analysis and consultation as the Review and the report itself.

Issues of scope

It is important that there should be clarity around the scope and coverage of the proposed recommendations.

UK and EEA BOFIs

Corporate governance issues are essentially organisational and prudential matters, which in the European context generally lie within the remit of the home state regulator. Many of the most significant BOFIs are global businesses headquartered elsewhere. There is a real issue about how far the FSA would be able to seek to apply UK corporate governance requirements in respect of BOFIs passporting in from EEA states by establishing branches in the UK, or indeed at the level of the EEA parent level of a UK BOFI subsidiary. There is also a question about how the proposals for consolidated supervision currently under discussion at international level might impact on the FSA's ability to apply UK corporate governance requirements to a UK firm whose lead supervisor is not the FSA, or to other foreign BOFIs more generally.

Non-listed BOFIs and non-EEA BOFIs

A key issue for non-UK BOFIs will be the extent to which there is consistency between the home country (and any other) regulations that will apply to them and what is adopted in the UK. It would not be appropriate for the FSA to seek to apply best practice standards derived from the current UK review of corporate governance to non-UK BOFIs until more progress toward international convergence in corporate governance standards has been made and there is greater clarity for firms around the "understandings between regulators" (important factors which are referred to in the report).

Further, and recognising the emphasis on properly "explaining" deviations from the Combined Code in appropriate circumstances, in respect of non-listed and foreign BOFIs, it is not immediately apparent to whom explanations should be addressed (in the absence of an institutional shareholder base), nor what the purpose of such explanation should be. Although the regulator might be a potential candidate for the receipt of such explanations (since the corporate governance of all BOFIs is a matter of regulatory interest), it is not entirely clear what role, if any, it is envisaged that the FSA should play in respect of such explanations. There is also the concern that,



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without any incentive to be flexible, the regulator may itself adopt a "box-ticking" approach and not entertain appropriate explanations.

As is acknowledged, the report has not worked to a strict legally-based definition of "other financial institutions", but interprets the term expansively. It is suggested that the term could cover all FSA-regulated institutions, although Annex 4 confirms that the Review's core interest is larger financial institutions, particularly those that are listed. The preface to the report effectively acknowledges this, noting that the principal focus of the Review has been on banks, and that many associated conclusions and recommendations are relevant, if in lesser degree, for other major financial institutions. There are also many different business models, and thus levels of exposure to systemic risk, amongst different financial institutions.

Given the above, and the fact that the recommendations are proposed as "best practice", we believe it may well be disproportionate and overly prescriptive to expect financial institutions which are smaller and of less systemic significance to comply with some of the recommendations. Although it is open to financial institutions to explain a decision not to comply, there is a real issue about whether investors will be prepared to accept such explanations in practice (or whether this will in fact encourage a "box-ticking" approach to compliance with the Code). This could be the case for smaller listed BOFIs who, for appropriate reasons, seek to explain a deviation from a provision in the Combined Code which is complied with by larger systemically important BOFIs – the concern is that investors may not be willing to accept a different (even if appropriate) application of the Code for them. The problem is even more acute for smaller non-listed BOFIs who may find themselves required to "explain" to the regulator, but may find that the explanation is not accepted.

It would therefore be helpful for the report to provide greater clarity regarding the extent to which the various proposals should be of general application to smaller institutions, and to those which are not listed.

Issues of potential liability

As authorised persons, BOFIs are subject to the FSA's Principles for Business, and the FSA is increasingly prepared to take action for breach of Principles instead of rule-breaches. If, and to the extent that the recommendations made in the report are incorporated, directly or by reference, by FSA into its handbook as rules, FSA-regulated listed companies will be bound to comply with those requirements.

Listed BOFI companies are also bound by the Listing Principles, and the listing and disclosure rules. Most recently, in List! 22, the FSA confirmed its readiness to take enforcement action on the basis of breach of the Listing Principles alone.

The report should consider the impact of requiring smaller listed BOFIs to "comply or explain" in respect of the full range of recommendations being made. The FSA, as the UK's Listing Authority, has a mechanism for enforcement action (fine/public censure) against issuers (and persons discharging managerial responsibility within an issuer) if they do not take reasonable care to ensure that nothing likely to affect the import of the information is omitted and that any explanation is not misleading, false or deceptive.



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Non-compliance or failures to take reasonable care in making explanations may therefore expose firms, senior managers and NEDs with relevant responsibilities to enforcement action. Even if the recommendations are not incorporated into the FSA handbook, "good practices" identified in the report may become the standard against which the regulator measures whether any regulated firm's affairs are responsibly and effectively controlled. It would be helpful if the report would clarify how it envisages issues of liability should be dealt with, particularly in circumstances where an explanation for non-compliance has been given.

Board size, composition and qualification

Although we accept that the role of a NED in a systemically significant BOFI will inevitably represent a substantial commitment, and that this may well in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere, we believe that the specification of 30 to 36 days might be overly prescriptive if applied to the whole range of BOFIs, and particularly in respect of BOFIs which do not represent a systemic risk and which are smaller in size (and who may have issues in successfully "explaining" any deviation from the recommendations) as explained above [Recommendation 3].

It is also important to recognise the potential consequences of the recommendations (viewed cumulatively) for the legal liability of NEDs, and the fact that these will have a knock-on effect on the standards expected from them in the discharge of their duties.

We note and agree with the comments in the body of the report about the need for balance within the constitution of a BOFI board, and would support a recommendation which reflects that concept.

Functioning of the board and evaluation of performance

There is a risk that the requirement for annual re-election of chairmen could encourage short-termism and undermine focus on long-term results, and might have the potential to destabilise boards. The willingness of shareholders to assess performance against longer-term criteria will be critical, and in this context we note that in the run-up to the financial crisis, there is some evidence that shareholder focus on short term share price performance may have contributed to less prudent behaviour by boards. We can see an argument that an annual re-election should not prove a significant difficulty in practice, provided that investor engagement, boardroom behaviour and risk management can be dealt with effectively, but we question whether the formal requirement for it would distract from the general emphasis on engagement and from focus on the longer term, and potentially increase the leverage given to short term activist investors [Recommendation 10].

The role of institutional shareholders: communication and engagement

Institutional shareholders with fiduciary duties

There are tensions inherent in the fact that the role of many shareholders is to invest in, rather than to take ownership of, companies. Institutional investors may owe fiduciary duties to their clients, and are required to act in the best interests of those clients, not of the company. Selling may be a "blunt" instrument for conveying messages to the company, as the report says, but it may well also be in the best interests of the fiduciary's clients, being more cost and time-effective, and less risky for the fiduciary, than engaging in protracted debate with the executive [Recommendation 19].



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Potential legal/ regulatory issues affecting shareholder engagement

As the report acknowledges, there are issues arising from regulatory and legal restrictions on the exercise of full engagement, for example the concert party rules and rules on the timing and content of communications between boards and shareholders. Although regulatory efforts have recently been made to address concerns that collective shareholder activism could be constrained by regulatory rules, we have some reservations about the comfort which the FSA has sought to provide. The FSA's guidance leaves open the possibility of argument about whether particular action is "solely aimed at exerting influence intended to promote generally accepted principles of good corporate governance", and there is also a question as to whether the guidance is consistent with the EU Acquisitions Directive, given that the guidance drafted by the Level 3 committees in respect of what constitutes "acting in concert" is formulated in very wide terms. There remains a concern that overseas regulators with relevant jurisdiction may take a different view from the FSA on this point. The resulting uncertainty leaves shareholders exposed to potential risk, and this is a matter on which further convergence is desirable, both within Europe and internationally.

The core issue of when it will be appropriate to share price sensitive inside information with shareholders and make them "insiders" will also remain. Shareholders will continue to be concerned that they should not be brought over the wall and prohibited from trading any earlier than necessary. Further, enhanced communication with some shareholders needs to be balanced against the principle of equal treatment of all shareholders.

Memorandum of Understanding

For these reasons we also have reservations about the proposals for a Memorandum of Understanding to be designed by an initial group of long-only shareholders. It will be important to ensure that any formal Memorandum of Understanding does not detract from the ad hoc nature of discussions where firms were intending to rely on the FSA's or the Takeover Panel's guidance regarding "acting in concert". The FSA has traditionally been reluctant to undertake the kind of role envisaged in paragraph 5.45 of the report, namely to engage in a process of confirming that individual MoUs comply with applicable regulatory restrictions comply with applicable regulatory provisions relevant to control and market abuse, or to provide safe harbour reassurance. In addition, should it be intended that investors pool their duties or approaches to companies, the extent to which they will wish or be able to rely on each other in discharging their duties to investors may be limited. It remains to be seen whether this proposal will be welcomed by the FSA or by institutions [Recommendation 21].

Material changes to the share register

It is not clear to us in what capacity it is envisaged that the FSA should be ready to contact major selling shareholders in the event of substantial change to a BOFI share register in a short period – as financial regulator or as competent authority for listing – nor what it is envisaged that the FSA would do with the information were it able to obtain it. If the FSA is to question major selling shareholders about their motivation for selling, this would represent a significant expansion of the FSA's remit. The FSA has the power to require the production of specified documents in connection with a general investigation into the state of the business or the ownership of an authorised person, but it not to require a former shareholder to attend and answer questions or



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provide information in the absence of suspicion of regulatory misconduct¹ or a criminal breach. We have some reservations about the extent to which the FSA has the resources effectively to intervene in discussions between investors in individual companies, and whether, in the absence of a concern about market abuse or other misconduct, it should do so [Recommendation 15].

Disclosure of engagement policies

Whilst the disclosure of engagement policies by institutional investors may be a good idea in principle, how effective this measure will be in practice remains to be seen. There is a risk that, in practice, such disclosures will be drafted in broad or general terms to cover various possible investment and engagement scenarios (institutions legitimately wishing to keep their options open and not, for example, wishing to lock themselves into an investment unnecessarily). Further, disclosure will not assure adherence to the policy given that there will be circumstances where it will not be appropriate for the policy to be followed [Recommendation 19].

Application and scope of the Principles of Stewardship

It is not clear precisely to whom the Principles of Stewardship should apply, nor what effect the "comply and explain" approach should have. Is it intended that funds with short-term strategies should observe the Principles unless a clear explanation is provided (long-term only funds are not necessarily also long-term holders)? If "comply or explain" is mandatory, this may have the unintended effect of suggesting that long-term strategies are a preferable style of investment, which may be true from the viewpoint of the firm in which the investment is made, but is not necessarily true for the underlying clients to whom the investment manager owes a fiduciary duty. These recommendations could pose particular practical difficulties where strategies for individual funds change [Recommendations 19, 20].

According to the Institute of Directors, UK institutions now own less than 50% of the UK equity market (the fragmentation of ownership being acknowledged in the report). Inevitably, rules which target only UK institutional investors will be of limited effectiveness, at least unless and until the recommendations obtain more international adoption, as the report hopes will be the case in the longer term [Recommendations 14 – 22].

Governance of risk

Many of the report's recommendations regarding the establishment of independent risk committees are an extension of existing good practice. The FSA's Senior Management Arrangements, Systems and Controls rules already require authorised firms to have effective processes in place to identify, manage, monitor and report the risks to which they are or might be exposed.

Risk committees

Some organisations already have board level risk committees, some of which have NED membership and some of which may not. Some organisations may have a combined audit and risk committee, while other organisations run separate committees. There is no "one size fits all" approach, particularly given the varying complexity of business models. We are concerned that recommendations 23 and 24 may be overly prescriptive and not wholly appropriate for some

¹ Including breach of the Disclosure and Transparency rules.

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smaller less complex BOFIs, which may be able to ensure that risk oversight is properly dealt within existing structures. In general, it should be open to the board to decide on the appropriate structure for its specific needs. It will also be important to ensure that where internal audit and risk functions are split, close liaison is maintained [Recommendations 23 and 24].

Board responsibility for risk management – the role of risk committees

Whilst there may be advantages in having a committee whose focus is on risk, a committee structure carries its own difficulties. Requiring delegation of responsibility for advising on risk to one committee carries a danger that boards as a whole may step away from systematically considering risk or viewing it as their primary responsibility. We believe that risk management should ultimately be a question for the board as a whole and it should be at the heart of decision making throughout the organisation. Ultimately there will always need to be a prudent balancing of risk against opportunity, and responsibilities for drawing that balance must in our view rest with the board.

In our view, the role of the risk committee should be similar to that the informal contract between the NEDs and the executive. The risk committee should be "challenging", but once a board decision is reached, fully supportive of the implementation of that decision. The risk committee must not be drawn into an approach which assesses risk in isolation and gives inadequate weight to countervailing factors [Recommendations 23 - 25].

Due diligence

We do not believe that it is right to prescribe that a non-executive board committee should oversee a due diligence appraisal of a proposed strategic transaction involving acquisition or disposal – we believe that the board as a whole should decide how best to manage the process on each occasion, in order to maintain ownership of the decision. It may be appropriate for a risk committee to consider certain M&A related risks and highlight these to the board as part of its "challenging" role (as discussed above). But it should then be for the board as a whole to decide on particular issues and deal with the risks [Recommendation 26].

Remuneration

Although we agree that there is merit in aligning remuneration policies with risk management, we think it is important to bear in mind Lord Turner's conclusion that remuneration structures played a considerably less important role than other factors in the financial crisis. Clearly it is helpful for remuneration committees to ensure a consistent approach to executive board, senior executive and wider employee remuneration.

It is however vital to ensure consistency with regulatory approaches both domestically and internationally. The proposals on remuneration will only achieve the desired objectives if they are consistent with wider reforms on remuneration taking place on the European and international stage. Otherwise, to the extent that the recommendations are more prescriptive than measures agreed internationally, BOFI executives may be incentivised to seek employment abroad.

We do not think that a "one-size-fits-all" approach for all BOFIs is appropriate. Historically, for example, the insurance sector has not been known for the kind of remuneration structures that are commonly associated with banking. Even if a need for remuneration reform in the insurance sector



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is identified, the Association of British Insurers has its own, albeit voluntary, remuneration policies and practices guidelines for insurers, which could be extended to include other employees [Recommendations 28, 29].

The onerous responsibilities placed on remuneration committees may discourage directors from sitting on the committee, particularly since the extended remit of remuneration committees will significantly increase the burden and time commitment required.

There are a number of legal and tax issues, as well as practical difficulties, surrounding the operation of clawbacks. Greater emphasis might instead be given to deferral and forfeiture, where the employee would not actually become entitled to the monies until appropriate performance measures have been satisfied [Recommendation 33].

Disclosure of remuneration bands for high-end executives is proposed in order to serve "shareholder and public interest." There is however a risk that because the data to be disclosed may well be market sensitive, its publication could lead to competition issues. Requiring publication of remuneration bands in smaller companies may also lead to specific individuals being identified [Recommendation 31]. We also consider that it may be difficult, in practice, for shareholders and the public to assess whether a particular level of remuneration is appropriate without a deeper understanding of the circumstances in which the remuneration was paid [Recommendation 36].

We trust that these comments are helpful. Please do not hesitate to contact Gareth Roberts (020 7466 2322) or Greg Mulley (020 7466 2771) should you wish to discuss any of the issues we raise in more detail.

Yours faithfully



Herbert Smith LLP

