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The Walker Review of the Corporate Governance of the UK Banking Industry
HM Treasury
London SW1

Dear Sir

Summary of recommendation

That s. 172 of the Companies Act 2006 be amended by adding a seventh factor to the six factors to which a director must 'have regard' in carrying out the duty to act in the way he or she considers to be for the 'benefit of members' as a whole. The seventh factor would require in terms that in the case of deposit taking entities the director must have regard to the interests of depositors.

Explanation of the recommendation

Under section 172 of the Companies Act 2006 a director of a company must act in a way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

However sub-section 172(1) provides that in fulfilling that duty a director must "have regard (amongst other matters)" to six factors, namely:

- (a) the likely consequences of any decision in the long-term;
- (b) the interests of the company's employees;
- (c) the need to foster the company's business relationship with suppliers, customers and others;
- (e) the impact of the company's operations on the community and the environment;
- (f) the desirability of the company maintaining reputation for high standards of business conduct; and
- (g) the need to act fairly as between the members of the company.

The foregoing duty is subject to any enactment or rule of law requiring directors, in certain circumstances (i.e broadly when the company is in trouble), to consider or act in the interests of creditors of the company, thus preserving the regime applicable where the company is or may become insolvent.

S. 172 came into effect in October 2007, but the common law prior to that date also required directors to act in the best interests of the 'members' of the company present and future.

One of the many striking features of the banking crisis is how different banks and other deposit taking entities are from other corporate trading entities. Amongst these differences is that the attraction and protection of depositors in order to carry on the underlying business creates a unique potential conflict of interest between the needs of shareholders and the needs of depositors.

Anecdotal evidence suggests that in the years of plenty leading up to the banking crisis shareholders in banking institutions put pressure on the boards of those institutions to return capital either in the form of high dividends or capital distributions. Moreover the years of plenty only existed because of the ability and appetite of banks to raise money through the wholesale market in widely differing ways some of which were highly unconventional- as distinct from building reserves from conventional depositors. And yet, neither boards nor internal auditors nor risk managers-let alone the activist shareholders- appeared to be asking themselves the question as to whether such methods of funding and the payouts to shareholders were putting deposits in jeopardy.

It is submitted that the duties under s 171 (and under s.174 –duty of care etc) can only at a real stretch of interpretation be construed as including depositors in financial entities within their personal duties , and that had directors been under a specific and personal duty to ask themselves the question as to whether they had had regard to the interests of depositors in acting allegedly in the best interests of " members " then the "paper trail" would have had to demonstrate that the directors had given their minds to this issue and the evidence for that view. It is impossible, of course, to know whether in itself this would have put a brake on the exuberance, but at least for the future it might be a very useful tool for non-executive directors looking for reasons to be cautious to have in asking the right questions and also withstanding pressure from shareholders.

Yours faithfully

Richard Smerdon

[by way of background personal details, I should explain that I retired in 2002 as senior corporate lawyer of Osborne Clarke ; I am the author of "A practical guide to corporate governance", now in its third edition, published by Sweet & Maxwell ; I am currently editor of "Practical Governance" and Gee's corporate governance handbook, published by Wolters Kluwer UK, and I am the rapporteur to the All-Party Parliamentary Group on corporate governance – www.appcgg.co.uk]

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