

Walker Review of Corporate Governance in UK Banks and Other Financial Institutions

On November 26, 2009, Her Majesty's Treasury ("HM Treasury") published the final version of the independent review (the "Review")¹ 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. The Review is a revised version of the draft review (the "Draft Review") that was released on July 16, 2009, which was summarized in our memorandum of July 28, 2009. 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 summarized below by reference to the five key areas examined by the Review. The Review proposes that the majority of the Recommendations are enforced through inclusion in the Combined Code on Corporate Governance (the "Combined Code") or a separate Stewardship Code for institutional investors which, like the Combined Code, would apply on a "comply or explain" basis². It would be for the Financial Reporting Council (the "FRC"), which has been closely consulted during the course of the Review and is currently reviewing the Combined Code, to decide exactly how this would be done.

The Review also proposes that the Financial Services Authority (the "FSA") will consider how to take forward the recommendations that apply principally to financial institutions, and that the recommendations on pay disclosure should be enforced through legislation in the forthcoming Financial Services Bill. The extent to which the FRC will amend the Combined Code is yet to be finalized. The FRC aims to publish its final

¹ Available at: http://www.hm-treasury.gov.uk/d/walker_review_261109.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. Proposed changes to the Listing Rules will however result in a change in the requirement to adopt the Combined Code.

report, and to begin consultation on whatever changes may be proposed to the Combined Code, before the end of the year. Subject to the outcome of that consultation, a revised Combined Code would apply to financial years beginning on or after 29 June 2010. We will be monitoring the FRC's report and its proposals in relation to the Recommendations.

1. Board size, composition and qualification

The Review focuses on the actions of BOFI boards, rather than their size or organization. The Recommendations in this area have been relaxed as a result of the consultation that followed the Draft Review (the "Consultation"), and the application of a number of the Recommendations has been limited to FTSE 100-listed banks or "major banks" – a term that is used frequently, but not defined, in the Review – rather than all BOFIs. The Review recommends that the overall time commitment of non-executive directors ("NEDs") as a group on the boards of FTSE 100-listed banks or life assurance companies should increase. Although the Review provides that the manner in which a particular board achieve this object will depend on the composition of the NED group on the board, it expressly recommends that, in the case of a major bank board, a minimum time commitment of 30 to 36 days a year – up to 50 per cent. greater than the current average of 20 to 25 days – should be clearly indicated in the letters of appointment of "several NEDs". Where so substantial a time commitment is not "envisaged or practicable" for particular directors, the Review indicates that the letter of appointment (which should be available to shareholders) should specify the time commitment agreed between the individual and the board.

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. Walker 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 emphasizes the need for BOFI NEDs to have financial industry experience and increased education and support, to enable them to engage in a pro-active manner in board deliberations, above all on risk strategy. It stresses that "independence of mind", together with financial 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. In a move that will surprise some corporate governance experts, the Review also expresses the view that the prohibition on CEOs stepping up to the chairman's role could be lifted, although Walker stops short of recommending a corresponding amendment to the Combined Code, noting instead that, where such an appointment is made and a clear justification is provided, shareholders and fund managers should interpret the Combined Code in a flexible manner.

2. Functioning of the board and evaluation of performance

The Review recommends that the chairman of a BOFI's board should combine experience with a proven record of successful leadership in a significant board position.

Where, at the selection phase, such a combination is only achievable incompletely, the board should give particular weight to convincing leadership skills, provided that there is an adequate balance of relevant financial industry experience among other board members. The Review concludes that “financial industry experience without established leadership skills ... is unlikely to suffice”. The Review recommends that an intensive induction and continuing business awareness program should be provided to ensure that the chairman is kept well informed of significant new developments in the business.

The chairman of a major bank 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. Walker has explained separately that this requirement will mean that, in practice, such chairmen cannot chair other companies. Following the Consultation, however, this requirement no longer extends to all BOFI chairmen. The Recommendations state that, depending on the balance and nature of their business, the required time commitment should be “proportionately less” for the chairman of a “less complex or smaller bank, insurance or fund management entity”. The Review also proposes that the chairman of a BOFI board should be proposed for election annually, and that the board should keep under review the possibility of requiring the annual election of all board members.

The Review recommends that NEDs should be ready and encouraged to challenge and test the executive board’s strategy proposals and that the board should be required to evaluate its performance every two to three years, with the assistance of external advisers, and to summarize 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 since, according to Walker, “[they] enjoy the privilege of limited liability whereas taxpayers have ended up assuming unlimited liability in respect of the big banks. Early preventive medicine through shareholder engagement can save everyone substantial time and money later on”. The Review also proposes extending the FRC’s remit to encompass the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. The FRC indicated, in the progress report on its review of the Combined Code, which was released on July 28, 2009 (the “FRC Progress Report”)³, that it would be willing to consider taking on such an enhanced role. The Review provides that the FRC’s new role should be clarified by separating the content of the Combined Code from the newly proposed “Stewardship Code”, and that the FSA should require institutions that are authorised to manage assets for others to disclose clearly on their websites or in other accessible form the nature of their commitment to the Stewardship

³ Available at:
http://www.frc.org.uk/documents/pagemanager/frc/Combined_Code_2009/Web_changes_to_2009_REview_of_the_Combined_Code_July_2009/Combined%20Code%20review%20progress%20report%20July%202009.pdf

Code or their alternative business model. The Review also recommends the publication of the voting records of fund managers and other institutional investors.

4. Governance of risk

As with other areas of the Review, a number of the Recommendations in this area have been relaxed as a result of the Consultation and the application of a number of the Recommendations has been limited to FTSE 100-listed banks or “major banks”. The Review recommends the creation of board risk committees, separate from audit committees, to oversee the activities of the boards of FTSE 100-listed banks and major banks and advise them on their current risk exposure and future risk strategy. The risk report of the board risk committee (or board) should be included in the annual report and accounts. A further 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 required. The Review recommends that the board risk committee should ensure that due diligence is undertaken 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. In relation to the Draft Review, Walker stated 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, if implemented, would require, among other things:

- (i) Remuneration committees to scrutinize the pay of all individuals in a BOFI who perform a “significant influence function” for the entity or whose activities have, or could have, “a material impact on the risk profile of the entity” (a “High End Employee”). This represents a significant retreat from the Draft Review, which recommended that remuneration committees should scrutinize the pay of those executives whose total remuneration was in excess of the executive board median. This reflects an acknowledgement that the Draft Review’s definition had “the disadvantage that what might be entirely reasonable differences in approach between and among banks complicated and potentially vitiated the process of comparison”. Instead the new definition draws on the definitions now being used by the FSA in its Remuneration Code (the “Remuneration Code”);
- (ii) The remuneration committee report for the 2010 year of account and thereafter for FTSE 100-listed banks and “comparable entities such as the largest building societies”, as well as FSA-authorised banks that are UK-domiciled subsidiaries of non-resident entities, to disclose in bands the number of High End Employees, including executive board members,

whose total expected remuneration in respect of the reported year is in a range of: (a) £1 million to £2.5 million; (b) £2.5 million to £5 million; and (c) £5 million bands thereafter, and, within each band, the main elements of salary, cash bonus, deferred shares, performance-related long-term awards and pension contribution. Such disclosures should be accompanied, to the extent possible, by an indication of the areas of business activity to which these higher bands of remuneration relate;

- (iii) Executive board members and High End Employees in a BOFI that is included within the scope of the Remuneration Code to 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. The Review recommends that this structure should be incorporated in the Remuneration Code review process, and that the remuneration committee report of a BOFI for the 2010 year of account and thereafter should indicate, on a “comply or explain” basis, the extent to which an entity’s remuneration arrangements conform with this structure;
- (iv) The remuneration committee report to disclose whether any executive board member or High End Employee has the right to receive enhanced benefits beyond those already disclosed in the directors’ remuneration report; and
- (v) Remuneration committee chairmen to 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, with some additional BOFI-specific elements to be taken forward through the FSA.” Although the Recommendations address the governance of BOFIs only, Walker has made it clear that, in his opinion, the Recommendations should be applied to all UK listed entities. Commenting on the Draft Review, Walker 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?” While recognising that “the relevant guidance and provisions require amplification”, the Review’s only proposal for new primary legislation relates to the mandatory disclosure of remuneration of High End Employees.

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 the consultation period in connection with the FRC’s review commenced,

he was inundated with arguments against amending the Combined Code, particularly in relation to non-BOFIs. The FRC Progress Report noted that: “The FRC has reached no conclusions at this stage on whether Sir David’s recommendations – which are still subject to consultation – should be extended to all non-financial listed companies, or to a sub-set of such companies, for example FTSE 100 or FTSE 350 companies or companies in specific sectors”. The FRC Progress Report does, however, indicate a willingness to consider amendments to the Combined Code, where necessary, and, in commenting earlier in 2009 that “[the] credit crisis was the result of a massive failure of governance at every level”, Sir Christopher Hogg hinted that his report will echo the Review in calling for stronger chairmen, a larger number of qualified directors, tighter controls on pay and formal reports on risk management. In a press release that coincided with the release of the Review, the FRC announced, in relation to those recommendations assigned to the FRC, that, as part of its review, it “proposes to adopt the recommendations in [the Review] that it considers after consultation are appropriate for all companies”.

The extent to which the Recommendations will eventually apply to non-BOFI listed entities remains to be seen. That 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 - if any - are applied merely to BOFIs or to all companies that are required to comply with the Combined Code. The FRC has confirmed that its report will be published in early December 2009, together with a revised Combined Code, which will be subject to consultation. It is anticipated that a revised Combined Code will apply to financial years beginning on or after 29 June 2010.

* * * *

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.

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