01 SEPTEMBER 2010

Response to EU Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies

By

Association for Financial Markets in Europe

Re: "Corporate governance in financial institutions and remuneration policies"

General Question 1:Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

Our answers to the Commission's specific questions are, unless otherwise stated, written from the perspective of a large, listed parent entity of systemic importance and of unlisted entities of global firms. The answers would be different if written from the perspective of an unlisted EU subsidiary.

We agree with the assessment articulated in the consultation that in the recent past there appears to have been a lack of Board commitment in some banks with respect to a Board's responsibility for setting the risk tolerance/appetite for the company and for the wider group of companies (the enterprise). We also agree with the assessment that the Boards of some banks have failed in the past to ensure the establishment of an independent and competent risk management structure and process which was capable of identifying, measuring, controlling risks or overseeing results.

We consider that it is appropriate that each Board ensure that a specified risk management process is put in place with responsibility for developing the parameters of the enterprise's risk appetite and tolerance as well as ensuring that a risk control structure and process is operating. This should be tailored to the firm's business model and commercial/economic environment in order to independently identify, assess, and control risks faced by the enterprise. We agree with the proposal that the Board consider establishing a Risk Committee, chaired by an independent director, to oversee the risk function and report to the Board; This is one among a number of potentially sound approaches. It may also be appropriate for each financial enterprise to have a Chief Risk Officer (CRO) with access and accountability to the Risk Committee or the full Board. This individual should be empowered to assess financial risk issues independently of business executives as well as to oversee the risk management structure throughout the enterprise.

Association for Financial Markets in Europe
St. Michael's House • 1 George Yard • London EC3V 9DH • United Kingdom
T: +44 (0)20 7743 9300 • F: +44 (0)20 7743 9301 • www.afme.eu
Company Registration No: 6996678 •European Union Register of Interest Representatives No: 65110063986-76

It is important that, whatever risk management structure and process is approved by the Board, there cannot be any derogation of the Board's ultimate responsibility. Boards must charge themselves with the responsibility to understand the important risk aspects of all of the enterprise's businesses and ensure that the firm has the necessary personnel and technical resources to manage risk appropriately. The Board must ensure that its own culture encourages an independent assessment of risk and other issues which is not susceptible to being overreached at Board level by very strong business leadership.

In this respect, a Board should institutionalise its culture of independence through its own governance structure, process and the selection of directors. It should ensure that it is capable of overseeing the enterprise as a whole through oversight of the proposals and actions of senior executive management.

The need for proportionality

We support the reference to proportionality and believe that there must be sufficient flexibility to allow for the many different situations that may prevail. The Basel Committee seems to share this viewpoint, stating that implementation of governance principles should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank and the group (if any) to which it belongs. Crucially, it will be necessary for the bank's supervisors in each country to carry forward this flexibility in implementing principles and policies within the context of their local legal and regulatory frameworks. In our view it is critical that supervisors and governments do not promulgate prescriptive regimes and that Boards remain responsible for determining how to govern themselves and the optimal method of managing and controlling risk. In this regard we reference the consultations on corporate governance conducted by other international organisations including the OECD, FSB, and the Basel Committee on Banking Supervision. In particular, we reference the statement by the Basel Committee that sound governance can be achieved regardless of the form used by a banking organisation so long as several essential functions are in place.

While we accept that the proposals about risk management and Board governance are generally sound, understandably they do not set out a rigid and comprehensive governance path to be applied by every international finance group, nor do they deal comprehensively with the appropriate governance methodology between a parent company and its subsidiaries. It would be a difficult task to do either because there are many important variables in these contexts. No one paradigm would fit all international groups or all parent-subsidiary structures. So we advocate strongly that each Board should continue to have the responsibility to determine what governance measures are appropriate for the enterprise after considering its business model and legal/geographical structure. In particular we consider that:

- We believe it would be useful to make clear that the extent to which governance principles should be implemented by a particular subsidiary will be for the board of that entity to decide, subject to review by its supervisor.
- Since subsidiaries typically will benefit from the corporate governance structures applied at the parent level and the oversight of group employees, there should be no presumption or requirement that a subsidiary should replicate exactly the same corporate governance structure as its parent.
- We refer you to the clear benefits of ensuring harmonised standards and achieving a global view of risks point to the use of firmwide committees (with appropriate regional and entity representation) rather than establishing equivalent but independently operating committees for each relevant entity. We also believe, however, that there may be cases where it will make sense to have entity-specific committees operating in coordination with equivalent firmwide committees. For example, banks with firmwide audit or risk committees may also choose to establish one or more entity-specific committees to ensure detailed focus on the specific risks carried in the group's major subsidiaries.
- In addition, we suggest that there is less of a need to have non-executive directors or independent members on the boards of subsidiaries or on their committees, because strategic direction and oversight is driven by the group board.

The Role of Senior Management

There seems to be a general trend to increase the responsibility of the Board by assigning them task s currently carried out by senior management. We are concerned that this trend will inevitably overload the Board.

We remain convinced of the need to distinguish the Board's oversight role from the role of senior executive management in running the firm's business day-to-day and setting and enforcing lines of responsibility and accountability throughout the organisation. The direct role of senior management in ensuring the regular review of policies, processes and the control functions should also be recognised while differentiating the board's responsibility to ensure that the control functions are set up to operate independently and efficiently. The Board should satisfy itself through its dealings with senior management (and others if deemed necessary) that the control functions, policies, and procedures of the bank are robust, appropriate and proportionate.

In this light, we consider that it would be counterproductive and unfair to increase even further the potential liabilities of directors in general, or of non-executive directors in particular. Parent bank Boards are generally oversight bodies that are not charged with managing the daily activities of the company. Corporate governance codes should reflect this oversight role. For example, in a complex financial institution, there will be many subsidiaries and special purpose vehicles , and it is impractical for a Board to be aware of the details of individual entities to an extended degree. Applicable law and regulation should explicitly recognise the concepts of materiality and the ability to delegate when dealing with Boards' and directors' responsibilities.

Nevertheless, it remains the Board's responsibility to satisfy itself, its supervisors and ultimately its shareholders, that appropriate Board governance and risk management policies are in place. To do this, the Board must demonstrate a culture of challenge and independence at Board level and foster such a culture throughout the firm as well as an effective and comprehensive risk control process.

Specific Questions:

1.1. *Should the number of boards on which a director may sit be limited (for example, no more than three at once)?*

There should not be a stated maximum number of Board memberships for an individual because the size and complexity of companies (and consequently the time commitment required to deal with a particular Board's issues) vary so much. We agree that time commitment is one of the important issues to be agreed during the recruitment process and a prospective director and the Board needs to satisfy itself that a director will have the time to properly fulfil his/her role.

1.2. *Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?*

There should not be a prohibition. Whilst separating the role of Chairman from the role of CEO may be a sound approach for some companies, it may not be optimal for every financial institution. Boards should be permitted to make a determination as to which form of governance is most effective for the particular company, including whether the roles of chairman and CEO should be combined. Having the two roles combined may help ensure clarity regarding leadership and enable the company to speak with one voice. The chairman/CEO can serve as the focal point for information and communications from the company to shareholders, regulators and other external constituencies. This is particularly true in times of market turmoil or crisis when a Board must act with great urgency. It should also be noted that empirical studies are divided on whether separating the roles of chairman and CEO has had any impact on company performance.

1.3. *Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have* *adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?*

In light of the facts and circumstances facing the firm, the Board should consider the skills and experience levels required in a prospective director to ensure that the director will be able to deal with his/her anticipated assignments and contribute to the appropriate balance of the Board in terms of specific expertise, independence and ability to challenge the management team.

1.4. Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

In general we agree that increasing the diversity of directors should be helpful, since a Board's efficient functioning depends heavily on the collective skills and experience of its directors. However, there should not be a quota approach to increasing the diversity of any Board.

1.5. Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

There should not be a requirement that each Board commission an evaluation by an external evaluator. Each Board should decide the process by which its performance will be evaluated on a periodic basis. Some Boards may decide that an external evaluation is appropriate, but we note that the practice and principles of external evaluation are of recent design and are not fully developed or tested. It is difficult for an external party to evaluate the internal workings of a Board, especially since an external party could inhibit free discussion and the efficiency of Board meetings. Currently, a self-administered evaluation with anonymity of director's input is generally regarded as appropriate currently.

It would not be appropriate for there to be a detailed public statement to shareholders of the specific findings of any Board evaluations undertaken beyond noting that it has occurred and its general conclusion. A more detailed report would be likely to adversely affect the quality of the input to the evaluation. For similar reasons, we do not consider it to be appropriate to disclose the particulars of an evaluation of the Board to supervisors who will have developed their own views on the Board's functioning as part of the supervisory process. Here we note that a separate responsibility for senior management to report any material risk which threatens the enterprise to supervisors should be in place.

1.6. Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

A Board-level risk committee is an appropriate approach to dealing with the Board's risk setting and risk management responsibilities. It is preferred by many banks, but not all banks consider that a risk committee comprised of directors (and, in particular, a majority of non-executive directors) is optimal. As we note above, it is the Board which should determine the most effective governance arrangements for the enterprise. In some cases, as long as the Board or the Audit Committee of the Board receives sufficient reports and information to carefully and thoughtfully oversee material elements of firmwide risk, a separate risk committee may just add to organisational complexity without additional benefits.

The skill-set of the membership of any risk oversight body is very important. Its effectiveness is likely to be reduced if it is comprised of non-executive directors without specialist and detailed knowledge of risk measurement/management or the products and trading businesses of the enterprise.

1.7. Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

The Board must decide whether the risk committee and the audit committee should cross-populate each other. But generally, it is presumed that the risk committee would report back to the entire Board in any case and would meet with the audit committee as required. In addition, individuals may be reluctant to serve on a risk committee if they are not risk specialists.

1.8. Should the chairman of the risk committee report to the general meeting?

In our view the chairman of the risk committee (or equivalent) should be available to take questions at the annual general meeting; and a report on the work of the committee should be filed with the annual return.

1.9. What should be the role of the board of directors in a financial institution's risk profile and strategy?

The Board's role should include setting the risk tolerance/appetite parameters and overseeing the risk management of the enterprise which is designed and implemented by senior management. In that role, the Board should discuss and evaluate with senior management the company's major reputational, financial and operational risks, including market, credit, liquidity and other risks, as well as the guidelines, policies and processes for managing such risks within the parameters it has set. It should remain senior management's role to establish and operate the risk management process, systems, and controls throughout the enterprise.

1.10. Should a risk control declaration be put in place and published?

We note that this will shortly be covered by CRD Pillar 3 disclosure requirements, and additional measures need be undertaken. There should be global coordination of the general requirements for publication to achieve a level playing field in the world's major financial markets while avoiding duplication and minimising confusion.

1.11. *Should an approval procedure be established for the board of directors to approve new financial products?*

Generally, Boards should not be required to approve every new product unless a particular product represents an entirely new and sufficiently significant or material line of business. Most new products can be approved by management who could, also establish a special product approval committee.

1.12. *Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?*

We do not support such an obligation for Boards. Senior management already has such an obligation as a matter of regulation in some jurisdictions, and we support harmonisation of this requirement for senior management.

1.13. *Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?*

The Board should take into account the interests of their depositors and other stakeholders during its decision-making process. However, we do not believe that a new "duty of care" for directors or Boards should be introduced which would establish legal liabilities that could be the basis of claims by stakeholders. To establish such potential liabilities would have very serious ramifications for companies and Board members, which may hugely diminish the pool of willing directors.

General Question 2:Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.

We agree that it is appropriate for financial firms to consider the proposed measures for their risk control function, if they have not already done so. Parent Boards are responsible for setting risk parameters for the enterprise and for ensuring that there is an independent risk management structure and process in place which extends throughout the enterprise to independently identify and assess risk. The risk committee or its equivalent must oversee the operation of the function and satisfy itself and ultimately its supervisor that there is a robust system and process in operation. Many financial firms will have a chief risk officer (or equivalent) in place with direct access to the Board and its committee charged with overseeing risk. The CRO should have firmwide remit.

Specific Questions:

2.1. How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

The chief risk officer (CRO) should be a senior individual at the firm with unfettered access to the risk committee or other committee designated by the Board (e.g. audit committee). To underpin his independence, his compensation should be set pursuant to a process designed to avoid pressure from business-line management, and termination of his employment should require the consent of the Board or the risk committee. The CRO will derive his status from his access to the Board and his firmwide remit. Thus, it is not necessary to peg the CRO's status with that of the CFO. Nor is there any necessity for the CRO to report to the CFO.

2.2. How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

The CRO should communicate regularly and directly with the risk committee or Board. He should have the status and opportunity to raise issues with any executive or non-executive director. Consideration should be given to having closed sessions between the audit committee, risk committee or Board and the CRO. As a matter of course, any risk issues falling outside the risk parameters set by the risk committee/Board should be raised at the risk committee or Board as appropriate.

2.3. Should the chief risk officer be able to report directly to the board of directors, including the risk committee?

Yes.

2.4. Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?

Firms should have systems that allow senior management to monitor their risk exposure on a day-to-day basis. As well as receiving regular reports, the risk committee (or equivalent) should be alerted in situations where a material change in risk has occurred. The IT systems should be of sufficient high quality to enable day-to-day risk tracking and prompt notice of any material breach of agreed risk parameters

2.5. Should executives be required to approve a report on the adequacy of internal control systems?

Yes. Such a report should be reviewed by the risk committee (or equivalent) for them to consider the adequacy of risk control systems from time to time. A public consultation on the content of such reports would be advisable to enable a consistent approach by financial firms.

General Question 3:Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

Specific Questions:

3.1. Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

We consider that tripartite meetings of a financial firm with both its auditor and its supervisor would be desirable annually in order to discuss issues arising from the auditor's work. In our view it makes sense for the financial firm to be present so that any questions can be addressed speedily and misunderstandings among the parties avoided. We are concerned that a bilateral meeting between an auditor and its client's supervisor would increase the risk of misconstruction by the supervisor and forgo an opportunity for clarification of facts by the regulated firm. We are also concerned that a formal bilateral meeting would alter the relationship between the auditor and its client and between the auditor and the supervisor. It should be remembered that the main role of the auditor is to confirm that the financial accounts of the enterprise present a true and fair picture. Their opinions on other matters may not be definitive.

3.2. Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?

In our view, the existing rules regarding the auditor's responsibility to report to the Board and the firm's supervisor are sufficient although it may be that they should be enforced more rigorously.

3.3. Should external auditors' control be extended to risk-related financial information?

The use of external auditors with respect to risk-related financial information should not be mandated by regulation. The determination whether to use auditors in this capacity should be left to the discretion of the Board or the relevant risk committee. Smaller firms may already use external expertise for their risk model/VAR review. However, some financial firms consider that auditors are not equipped to review VAR calculations for accuracy. Audit firms, in our view, would likely be reluctant to accept the potential liabilities that could arise from undertaking this work, particularly in respect of larger, more complex firms. For these reasons, their involvement would be very costly, and their bias to a very conservative view, stemming from their less informed perspective, could arbitrarily affect the competitive position of a firm.

General Question 4:Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.

We agree that supervisory authorities should take a more active approach to monitoring the Board and the independence and efficacy of the firm's risk management and control structure and process.

Specific questions:

4.1 Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?

Yes. Supervisory authorities should thoroughly review the risk management function of every regulated firm. With respect to the functioning of the Board, there is considerably more room for a divergence of views as to how a Board should govern itself. As noted above, given the differences in the size, complexity, and legal context among firms, there can be no universally appropriate way to organise a Board. Rather than mandating a particular board model, the supervisor's views should be outcome based i.e. asking whether the functions of the Board have been performed well and if there is a Board culture of independence and healthy challenge of senior executives. We note that there is evidence that some supervisors are already much more engaged and involved in this area.

4.2. Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?

We consider that supervisory authorities should thoroughly review the risk management function of every regulated firm. With respect to the functioning of the Board, there is considerably more room for a divergence of views as to how a Board should govern itself. As noted above, given the differences in the size, complexity, and legal context among financial firms, there can be no universally appropriate way to organise a Board and a firm's corporate governance more generally. Rather than mandating a particular board model, the supervisor's views should be outcome based i.e. (1) have the functions of the Board been performed well? and (2) is there a healthy Board culture of independence and thoughtful challenge of senior executives?

4.3. Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

Yes. In principle this is appropriate and some supervisors are already taking a role in the recruitment process. The balance of talents, skills, and experience on the Board must be taken into account. There is room for reasonable variance in judgement concerning questions of balance.

General Question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?

Shareholder involvement with financial institutions is in practice a mechanism for limited control of financial institutions. Realistically, it is a rather painstaking method because shareholders can always sell their shareholding to express their view. The fiduciary imperative faced by most institutional investors means that their first duty will always be owed to their end investors, and shareholder engagement will always be carried out against that imperative.

Specific Questions:

5.1. Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

Yes. They should be disclosed annually on a comply or explain basis (as discussed in the Working paper COM (2010) 285)[1] either in their annual report or on the appropriate website. However in this context, the Commission's attention is drawn to the unintended consequences of a blanket disclosure requirement. Investment banks routinely hold equity stakes pursuant to hedges of equity derivative transactions with clients. Investment banks typically do not vote such shares, as they are not held as an investment and voting would therefore be inappropriate. Care should be taken in contemplating any new requirement for disclosure of voting practices and policies to ensure that any voting policy disclosure requirement applies only to shares held as an investment.

5.2. Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

Yes - on a comply or explain basis[2]. We also refer the Commission to our comments on inadvertent consequences of a blanket disclosure requirement as set out in 5.2 above.

[1] Paragraph 4.2.1 of Working paper COM (2010) 285) refers to the Institutional Shareholder Committee Code on responsibilities of Institutional Investors (November 2009)

[2] As above.

5.3. Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to empty voting?

Subject to certain provisos, we do not object to the identification of shareholders to the company itself (at its own expense) for legitimate communication purposes. We note that companies are able to communicate generally with all shareholders using their website and other public media, and we suggest that legitimate communication be limited to announcements of corporate actions. The identification of shareholders to other actors such as fellow shareholders, or the market more generally, should not be unfettered because such information can be misused to the detriment of shareholders/ beneficial owners.

We propose that EU authorities undertake a thorough study of this potential issue in cooperation with national regulators. We also note that the issue of 'empty voting' is a significant part of another current consultation and propose the Commission defer decision-making on this point until the results of that consultation are known.

General Question 6:Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

<u>Specific Questions:</u>

6.1. Is it necessary to increase the accountability of members of the board of directors?

Some Member States are changing applicable governance codes to call for the annual election of all directors, which will increase directors' accountability to the shareholders who are the principal stakeholders in any public company.

Directors of financial firms are already subject to numerous legal and regulatory requirements for which they are accountable. We believe it would be counterproductive to introduce more onerous legal accountabilities for directors as it would diminish the pool of willing and qualified directors and indirectly limit the commercial activities of banks and their legitimate risk-taking activities.

6.2. Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

Harmonisation of directors' civil liability frameworks among Member States seems to be an appropriate goal, provided that the harmonisation is at a proportionate level. Please see our responses to 1.13 and 6.1 above. However, it would not be feasible or advisable to harmonise the criminal liabilities of directors, given the variances in the general criminal law among Member States.

General Question 7: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.

The financial services industry recognises the contribution that carefully crafted remuneration structures play in risk management. For this reason, AFME member banks welcomed the G-20 endorsement of the FSB Principles for Sound Compensation Practices and the related Implementation Standards (FSB Principles). We view the FSB Principles as affording sufficient flexibility while providing objective guidance. AFME member banks have all implemented – and have frequently exceeded – the FSB Principles.

Because the financial services industry operates in a global and competitive environment, our contributions on this topic[3] have stressed the importance of international coordination. The financial services industry relies on human capital to put financial capital to work in the most productive and efficient manner possible. Talent is limited; competition is keen; flexibility is paramount if the labour market is to function properly. Global respect for the principle that no nation or region should unilaterally impose extra burdens or bestow additional benefits is necessary to successful regulation.

Our contributions on this topic have also stressed the importance of placing responsibility for the structure and oversight of remuneration with the body with the requisite facts and expertise: the Board. We therefore welcome the opportunity to share our views on the objective of creating sound incentives and achieving fair outcomes through enhanced governance.

Specific Questions:

7.1. What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

As discussed above, we view the FSB Principles as a sensible global benchmark, which has addressed comprehensively the shortcomings of the structure and oversight of remuneration in the financial services industry. The agreed text of the most recent revision to the EU Capital Requirements Directive (CRD III) memorialises the FSB Principles, and adds "more specific commitments".[4]

---

[3] *See e.g.*, Memorandum from (AFME predecessor organisation) the London Investment Banking Association to the United Kingdom Treasury Committee on Incentive Structures and Executive Remuneration in the Banking Sector (17 November 2008); Letter to Ms. Claire Bury (Head of Company Law, Corporate Governance, and Financial Crime) and Maria Valentza (Head of Securities Market Unit) Regarding Commission Recommendation on Remuneration Policies in the Finance Sector (25 March 2009); Joint Response to CEBS Draft High-Level Principles of Remuneration Policies (3 April 2009); Joint Response to European Commission Consultation on Capital Requirements Directive (CRD) and Remuneration (7 May 2009); Joint LIBA SIFMA Response to FSA Consultation Paper 09/10 Reforming Remuneration Practices in Financial Services (18 May 2009); Joint LIBA SIFMA Response to FSA Consultation Paper 09/10 Reforming Remuneration Practices in Financial Services (18 May 2009); and Joint Letter to Sir David Walker Regarding A Review of Corporate Governance in UK Banks and Other Financial Entities (1 October 2009).

[4] European Parliament Press Service, "Frequently Asked Questions on the Capital Requirements and Bonuses Package (CRD3)" (2 July 2010), available at:

We believe that yet additional measures are unnecessary. Measures that regulate directors' pay more stringently would in fact prove detrimental by creating further disparity between the EU and other financial centres. If the Commission nevertheless deems it necessary or desirable to increase oversight, we believe it might take the form of additional disclosure. Any such measures should be carefully calibrated to facilitate informed investment decisions and, possibly, advisory shareholder voting that might prove helpful to the Board. The disclosure should not however be of such detail or particularity that it directly or indirectly (by allowing "reverse engineering") undermines a basis on which firms compete for talent or infringes individual privacy.

7.2. *Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?*

We do not see stock options as causing any problem that would be susceptible to resolution by government intervention and believe that the problem, if any, is better left with shareholders.[5] The strong corporate governance culture contemplated in the EU Green Paper should create the environment to monitor and adjust the alignment of incentives when and to the extent such action is thought necessary by stakeholders.

7.3. *Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?*

We share the Commission's view that "financial participation of employees in Europe is an important factor in group motivation and cohesion."[6] We note that this belief in employee ownership was sufficiently uncontroversial to have engendered an amendment to the Prospectus Directive to include schemes from non-EU countries.[7]

---

http://www.europarl.europa.eu/news/expert/background_page/042-77710-183-07-27-907-20100702BKG77709-02-07-2010-2010-false/default_en.htm.

[5] To the extent that the problem alluded to in the question is thought to result from a misalignment of directors' incentives with the long-term health of the institution, we would challenge the assumption. Significant empirical research points to a high correlation of the losses suffered by directors of failed institutions with the financial fortunes of those firms. See e.g., David Lapido and Stilpon Nestor Bank Boards and the Financial Crisis; A Corporate Governance Study of the 25 Largest European Banks" (May 2009), at page 15:

> "We have also found no evidence that under-performance was in any way linked to a lack of alignment with shareholder interests. Mirroring our findings in the US, we found that top executives in many of the banks that were worst hit by the crisis had more than adequate "skin in the game" in terms of exposure of their personal wealth to the fate of their bank's share price."

[6] *European Securities Markets Expert Group (ESME) Report on the Prospectus Directive (5 September 2007), at page 17.*

[7] *European Commission Press Office, Prospectus Directive: Frequently Asked Questions (24 September 2009), at question 2.2:*

> This current exemption in the Prospectus Directive specifically for offers of securities to employees does not apply equally to all employees, but creates a less advantageous situation for the employees of two categories of companies, namely third country companies that do not have a listing on a regulated market within the EU, and EU non-listed companies or EU companies that have securities traded on EU "exchange-regulated" markets. … Therefore, the exemption relating to employee shares

It is therefore both unsurprising and desirable that several Member States would afford the favourable tax treatment alluded to in the question. European companies that offer these schemes do so across the organisation (in the form of employee ownership plans) and the tax advantages that accrue do so in relatively small amounts across a broad constituency. We are aware of no evidence showing that these benefits have resulted in the type of risk taking discussed and believe that change to any aspect of a policy framework designed to encourage employee ownership would be disproportionate.

7.4. Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

Directors of European companies have direct legal responsibilities to stakeholders. The extent to which these responsibilities might need to be broadened or increased is the focus of this document, but the appropriate role for regulators in this area is to ensure transparency to shareholders and potential investors. Creating distortions and dilution through overlapping and/or different rights through intervention on particular elements of a business strategy (i.e. remuneration) for a particular industry is to be avoided. We welcome initiatives to afford shareholders and employees all appropriate means to feed constructively into decision-making. We are of the view that advisory votes on remuneration should be sufficient to accord shareholders a voice in this process. We oppose the creation of a formal legal role for employee bodies which could encroach improperly on Board discretion and impede the free movement of human capital.

---

schemes should be widened in order to cover the employee shares schemes of companies that are not listed on a regulated market.

Available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/412&format=HTML&aged=0&language=EN&guiLanguage=en.

7.5. What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

No AFME member supports rewarding failure; all agree that severance clauses in director contracts should be drafted accordingly. Severance packages, however, are also designed to give effect to a severance period that, under EU law, can be as long as five years. As discussed above, the labour market stagnates when a mutual agreement to terminate is delayed by a lengthy notice period or another contingency that could be reduced to a reasonable amount. As long as the severance provisions are reasonable, and are fully disclosed, these elements of an individual contract – themselves the product of regulation - should be as free as possible from additional regulation. The sole legitimate role for regulators in this area is to set notice periods which we would recommend be rebalanced to obviate the problem described.

General Question 7a: Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?

We refer you to our answer to question 7.1, above. The FSB Principles provide the appropriate global benchmark for regulation of remuneration in the financial services sector. Additional measures, beyond those already included in CRD III, should be the subject of global discussion, agreement, and coordinated implementation.

Specific Questions:

7.6. Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

Institutions in sufficient distress to have required extraordinary government assistance will almost invariably require extraordinary flexibility to navigate back to profitability. We believe it is unwise to constrain these entities pre-emptively. Constraints may prove appropriate, but should be analysed and imposed at the time, to the degree, and in the fashion agreed with regulators who can best judge the particular circumstances at the time they occur.

General Question 8:Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by markets alone is not always possible or effective.

<u>Specific Questions:</u>

8.1. What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?

Conflicts of interest are unavoidable in universal banking, but they can be managed in most cases by the financial firm, e.g. by the use of sufficient disclosure to allow clients to make an informed judgement. Over many years the use of information barriers-- sometimes called Chinese Walls- has been monitored and refined. Firms currently have to publish their conflicts policies in some jurisdictions and are monitored by regulators. We do not see a compelling argument for the introduction of further regulation of conflicts.

8.2. Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?

We are in favour of harmonisation of conflict rules, but full consultation should be undertaken to ensure proportionality and the avoidance of duplication.