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Register of Interest
Representatives:
ID # 89854211497-57

Brussels, 1st September 2010

Dear Mr Delsaux,

**Re: Green Paper, Corporate Governance in Financial Institutions and
Remuneration Policies**

Executive Summary

CFA Institute appreciates the opportunity to express our views on the proposals and considerations set out in the Commission's Green Paper, "Corporate Governance in Financial Institutions and Remuneration Policies."

As an organisation representing investment professionals, we promote shareholder involvement and good corporate governance. Our recommendations are thoroughly articulated in our *Corporate Governance of Listed Companies: A Manual for Investors*¹. Those recommendations are an integral part of our curriculum on all three levels of the CFA Program for which in total around 200.000 candidates study every year.

We firmly believe in shareholder democracy and that shareholders should have some measure of control over the companies they own. The recent financial crisis has however revealed flaws in this model which require a remedy.

In particular, many of the systemically important financial institutions that are considered "too large to fail" have shown governance weaknesses that need repair. While in general we do not support the perspective that some financial institutions are "too large to fail," we nevertheless recognize the reality that many policy makers have adopted this approach to dealing with such institutions when they fail. When these situations occur, governments and ultimately the taxpayers inevitably become stakeholders in those firms. Consequently, government action to improve the company law structures of these institutions is acceptable.

Therefore, we support the need for revisions to company law structures and the governance parameters under which these firms, in particular, operate. At the same time, we are not comfortable with legally binding provisions on corporate governance. Differences within organizations ranging from the experience and expertise of managers and boards, to the composition of loan and investment portfolios, and even to cultural differences among institutions and markets suggests that a one-size-fits-all, mandated

¹ <http://www.cfapubs.org/doi/PDF/10.2469/ccb.v2009.n12.1>



governance approach will not serve the interests of shareholders or other stakeholders in every, or possibly even in most cases.

Revisions to company law would be supplemented by a set of corporate governance best practices to guide financial institutions and the regulatory authorities that oversee them. The supervisor would evaluate how the firm operates relative to the best practice guidance, and if a firm were to violate too many of these practices, the supervisor could issue a warning and ask the firm to justify the deviations. If the deviations raise sufficient concern about governance factors that could lead to failure, the supervisor would have the authority to require the firm to develop a plan to improve its corporate governance, and to take further measures for failure to comply. We believe such a system would give supervisors an appropriate level of authority while at the same time leaving room for flexibility at the firm.

To increase shareholder participation and encourage them to take a more active role, it is necessary to strengthen their position, in particular vis-à-vis the board and executive management. One way to achieve this is to unbundle corporate resolutions presented to shareholders at general meetings, i.e. voting on one issue rather than several in a resolution. Institutional investors have a significant stewardship role on matters of issuer corporate governance. However, many choose not to exercise their rights. With this concern in mind, CFA Institute is working on a research project to investigate the impediments to stewardship and put forward solutions. The conclusions of this research project will be presented in a public report, scheduled for release in March/April 2011.

We believe that empowering investors and supervisory authorities as described above will promote better corporate governance of financial institutions. It will serve the interest of all stakeholder groups and improve financial stability.

Our response to the Consultation's specific questions is set out below. Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'C Cronin'.

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With headquarters in Charlottesville, Virginia, and regional offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association of more than 101,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 135 countries, of whom more than 89,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories. We have over 11,000 members resident in the European Union.

CFA Institute develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards (“GIPS®”), and the Asset Manager Code of Professional Conduct (“AMC”). CFA Institute is best known for developing and administering the Chartered Financial Analyst® curriculum and examinations and issuing the CFA Charter.

5.1. Boards of directors

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.

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)?*
- 1.2. *Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?*
- 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?*
- 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?*
- 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?*
- 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?*
- 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?*
- 1.8. *Should the chairman of the risk committee report to the general meeting?*

- 1.9. *What should be the role of the board of directors in a financial institution's risk profile and strategy?*
- 1.10. *Should a risk control declaration be put in place and published?*
- 1.11. *Should an approval procedure be established for the board of directors to approve new financial products?*
- 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?*
- 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')?*

1. In addition to the comments below there are a number of issues concerning the board which are not raised in the specific questions. Most notably, it is not sufficient to just separate the chairman of the board and the chief executive functions. CFA Institute believes that at least a majority of board members should be independent. An independent board member should not have material business or any other relationship with the company, or with its executive management, including their family members. A more thorough definition of independence can be found in CFA Institute's *The Corporate Governance of Listed Companies: A Manual for Investors*².

CFA Institute's *Manual* raises a number of related matters, which we draw to your attention these include:

- whether the board and its committees have budgetary authority to hire independent third-party consultants without having to receive approval from management;
- whether board members are elected annually or whether the company has adopted an election process that staggers board member elections;
- whether the company engages in outside business relationships (related-party transactions) with management, board members, or individuals associated with management or board members for goods and services on behalf of the company;
- to determine whether the board has established a committee of independent board members, including those with recent and relevant experience in finance and accounting, to oversee the audit of the company's financial reports;
- to determine whether the company has a committee of independent board members charged with setting executive remuneration/compensation;

² <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n12.1>

- whether the company has a nominations committee of independent board members that is responsible for recruiting board members;
 - whether the board has other committees that are responsible for overseeing management's activities in select areas, such as corporate governance, mergers and acquisitions, legal matters, and environmental health and safety issues;
 - how well the communications between the board and the shareholders functions and the ability shareholders have to meet with the board.
- 1.1 For systemically important financial institutions only, we support provisions that limit the number of boards on which a director may simultaneously sit.
 - 1.2 Combining the chief executive role and the role as chairman of the board is not advisable though it should not be prohibited by mandate for firms that are not systemically important. We support a legally binding prohibition for systemically important financial institutions that are government owned
 - 1.3 We agree it is important that recruitment policies specify the duties and profile of the board members in the recruitment policies, to ensure that the board has adequate skills drawn from a broad base of experience.
 - 1.4 We do agree that including women and individuals with different backgrounds on the board would enrich the board and potentially could improve its functioning and efficiency. However, we believe that the skills and competencies of the individuals should be the decisive factors for service on corporate boards, not gender or ethnicity.
 - 1.5 An evaluation of the board by an external and independent party could be useful, if its result is disclosed to investors and the competent authority. Nevertheless, we are not convinced that such a review should be either mandated, or that it could be mandated in a manner that could achieve a result worthy of the extra cost. We are concerned that if drafted without great care, it could lead to an evaluation of factors that are only tangentially related to board effectiveness, but at great cost to the company and its shareholders.
 - 1.6 We believe a risk committee can help enhance a financial institution's risk management. Ideally it should be composed by independent board members with knowledge and experience of risk management. For systemically important financial institutions, a risk committee (as described) should be a mandatory requirement.
 - 1.7 It is reasonable for to have one more members of the audit committee to be part of the risk committee and vice versa.
 - 1.8 We do not think the chairman of the risk committee should report to the general meeting. He should, however, be available for questions at the general meeting. We believe the chief risk officer, should present the risk report (to be part of the

annual report) which discusses the nature of the risks that the company is undertaking and how these risks are being managed.

- 1.9 The board has the ultimate responsibility to ensure that the firm's risk exposure is managed in an adequate and efficient manner. They should ensure that the company has policies and procedures to ensure that risks are monitored and managed. A firm wide risk-management process should identify, measure, and manage the risk position of the firm and its investments, including the sources, nature, and degree of risk exposure. The firm should also establish a business-continuity plan to address disaster recovery or periodic disruptions of the financial markets. The board should also direct management to ensure that the company's risk department has the technology and human resources needed and that the chief risk officer and his staff have adequate experience and education to fulfil their tasks. The chief risk officer, not the board, should be responsible for the day-to-day monitoring and management of risk and the administration of the policies and procedures.
- 1.10 Publishing the board of directors' approval of the risk strategy and profile in a public document (risk control declaration) seems reasonable. It can potentially contribute to good management and supervision of risks within financial institutions.
- 1.11 New products, which expose the firm to material risk, should be approved by the board.
- 1.12 The board of directors should inform the competent authority of any material risks they are aware of and also how they are managing these risks as part of the regular examination process for each institution by the relevant competent authorities.
- 1.13 In systemically important financial institutions, most notably those who are covered by deposit guarantee schemes, boards of directors already consider the interests of other stakeholders as part of their existing decision-making procedures, we identify this as a good practice.

5.2. Risk-related functions

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.

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?*
- 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?*

- 2.3. *Should the chief risk officer be able to report directly to the board of directors, including the risk committee?*
- 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?*
- 2.5. *Should executives be required to approve a report on the adequacy of internal control systems?*

- 2.1. The chief risk officer should have equal status and pay as the chief financial officer, in order to balance the finance department's interest of acquiring funds at the lowest possible cost and lending them on at the highest possible return, with a risk-adjusted framework imposed by a person of equal standing within the organisation. These two should cooperate closely but should both report separately to the chief executive officer. The chief risk officer should also report directly to the board as well as to the risk committee of the board as suggested under 2.3. He or she should also give a presentation at the general meeting of shareholders about the company's risk exposures and how these are being managed. Finally the chief risk officer should attend meetings between company representatives and investors (analyst meetings etc).
- 2.2. The communication between the risk management function and the board of directors will best be enhanced by the chief risk officer reporting directly to the board as suggested under 2.3.
- 2.3. Giving the chief risk officer the ability to report directly to the board, including its risk committee, will strengthen his or her status and authority. It will also enhance the communication between the risk function and the board.
- 2.4. Real-time surveillance of the company's risk exposure is the task of the chief risk officer and his/her staff. This officer should report to the board and its risk committee instantaneously if the risk exceeds agreed levels.
- 2.5. A report on the adequacy of internal control systems should be approved by the board. Its results should also be reported to the shareholders in the company's annual report.

5.3. External auditors

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?*
- 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?*
- 3.3. *Should external auditor's control be extended to risk-related financial information?*

- 3.1. In principle, cooperation between external auditors and the competent authority should not be strengthened. Boards, on behalf of their shareholders, hire these auditors to ensure the accuracy of what is reported about financial performance and financial condition. This type of cooperation has the potential to create a conflict for the external auditors about who their clients are. Moreover, auditors are not experts in risk management and other issues related to the markets which are of interest to financial supervisors. Hence, it is important that auditors are not given a role for which they are not equipped to fill.
- 3.2. We support increasing the awareness of external auditors to their duty to provide the board and the market, in general, which includes competent authorities, with information on serious matters that affect the health of the issuer.
- 3.3. There should be scrutiny of the risk-related information but we question whether the auditors are the most well suited to perform this task.

5.4. Supervisory authorities

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.

Specific questions:

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

- 4.1. We believe competent authorities should have an appropriate level of authority to ensure corporate governance of financial institutions does not lead to failure. Consequently, we propose a set of governance best practices to guide financial supervisors and the firms they oversee. The supervisor would evaluate how each firm operates relative to the best practice guidance, and if a firm were to violate too many of these practices, the supervisor could issue a warning and call on the firm to justify the deviations. If the deviations raise sufficient concern about governance factors leading to failure, the supervisor could require the firm to develop a plan to improve its corporate governance. Further, the supervisor would have authority to take further measures if the firm fails to comply. We believe such a system would give supervisors an appropriate level of authority while leaving room for flexibility at the firms.
- 4.2. We believe that a system as outlined under 4.1. above would be suitable also to check the proper functioning of the board and the risk management function. At a minimum there should be an annual inspection and examination.
- 4.3. CFA Institute supports an extension of the fit and proper test to cover technical and professional skills of future board members.

5.5. Shareholders

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?

Specific questions:

- 5.1. *Should disclosure of institutional investors' voting practices and policies be compulsory? How often?*
- 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.*
- 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'¹?*

Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

¹ Vote by a shareholder with no corresponding financial interest in the company for which they are voting, with potentially negative consequences for the integrity of the corporate governance of listed companies and the markets on which their shares are traded.

- 5 We firmly believe that shareholders should have appropriate mechanisms to exert control over the companies they own. The recent financial crisis revealed flaws in this system of control, some of which can be addressed through regulation and closer supervision. However, supervisors cannot run the companies; business decisions must be made by management under the supervision of the board on behalf of the shareholders. We are aware that shareholders have not always used their influence and thereby they have also failed to protect their own interests and, in some cases, the interests of society at large.

Part of the solution to increasing shareholder participation will be through strengthening the shareholder's position vis-à-vis the board and the executive management. One way to achieve this is to unbundle corporate resolutions presented to shareholders at general meetings, i.e. voting on one issue rather than several in a resolution.

Institutional investors have an important stewardship role on matters of issuer corporate governance. Many choose not to exercise their rights. However, with this concern in mind, CFA Institute has begun work on a research project to investigate the impediments to stewardship and put forward solutions. The conclusions of this research project will be presented in a public report, scheduled for release in March/April 2011. In the meantime we refer to our response³ to the UK Financial Reporting Council's consultation on its stewardship code.

5.6. Effective implementation of corporate governance principles

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

Specific questions:

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

6. We believe the governance oversight system discussed earlier would be the best way to ensure the effective implementation of a set of corporate governance best practices. Under this system, the competent authority evaluates how well a firm adheres to the best practices, can issue warnings for violation of too many of these practices, and can require firms to develop governance plans if the problems are

³ <http://www.cfainstitute.org/Comment%20Letters/20100430.pdf>

severe enough. The supervisor also would have the authority to promulgate sanctions to firms who despite the warning do not improve its corporate governance.

- 6.1. The duty and responsibility of board members should be clearly defined by company law structures. In particular, board members should have no doubt that they represent the interests of the shareholders and must act accordingly, especially in their interaction with each firm's senior management and chief executive. When failing in this fiduciary duty, civil prosecution and sanctions towards a board member should be possible (see 6.2 below).
- 6.2. Our belief is that civil liability is preferable to criminal liability. While civil liability does not permit imprisonment, we believe that a harmonized range of proportionate sanctions would represent an effective deterrent. The sanctions of being declared no longer 'fit and proper' or barred from serving as a board director at a listed company are severe punishments, particularly as they will affect the career and earnings opportunity of the convicted.

5.7. Remuneration

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.

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?*
- 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?*
- 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?*
- 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?*
- 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?*

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?

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?*

7.1. An important addition to EU-level remuneration measures would be to require firms to disclose the pay strategies, methods, justifications, and amounts on an annual basis for the highest-paid executives and board members. This information would help investors and shareholders alike determine whether a board's pay decisions are appropriate. CFA Institute's publication, *The Compensation of Senior Executives at Listed Companies: A Manual for Investors*⁴, provides a comprehensive discussion of disclosures that are helpful to investors.

7.2. In the same manner that the use of stock options is not appropriate for every company, it would not be appropriate to prevent some companies from using stock options to pay their employees. Consequently, we would not support a blanket EU-level prohibition on the granting of stock options, even for financial institutions. What is important and relevant is whether the board of directors uses prudence and care in deciding how and how much to pay their senior managers. And if shareholders as a whole determine that the board's decisions have not served their interests well, then the national company law structures should ensure that they have the means to replace those board members with individuals who may do a better job serving shareholders' interests.

7.3. Whilst favourable tax treatment may encourage the use of stock options by companies to pay senior executives and staff, it is far from certain that using stock options automatically leads executives to engage in excessive risk-taking. We do not believe it is an issue to be addressed at the EU level.

7.4. CFA Institute has long supported giving all shareholders a non-binding vote on the compensation packages awarded to senior executives. Such "say-on-pay" mechanisms, permitted through national company law structures, have encouraged communication between large shareholders and boards. These discussions have ensured that the pay packages are acceptable before the board makes a final decision on executive pay. We also support governance mechanisms that empower shareholders to use company proxy materials to nominate people for boards of directors. Beyond these factors, however, we believe it is the board's role to decide what to propose to shareowners about how and how much to pay senior executives, and any changes should occur at the national company law level.

⁴ See <http://www.cfapubs.org/toc/ccb/2007/2007/8>. This Manual covers governance issues related to executive compensation, as well as the different elements of compensation, and how these might affect investor decisions.

- 7.5. Whilst CFA Institute believes many golden parachute packages damage shareholder interests, we believe the appropriate means of dealing with these issues is through member states' company law structures and not at the EU level. Because some of these packages are used as de facto anti-takeover devices, we believe shareholders should have a binding vote on such packages.
- 7.6. Financial institutions that have received public assistance are using low-cost and, in some cases, tax-advantaged capital to support their operations. Consequently, the basis for variable compensation may overstate how well the firm would have performed if it had had to compete on an even playing field with institutions that did not receive or rely upon public funding. In this sense, these firms may overpay their executives relative to what they would have had to pay the same person for similar performance in a different firm. At the same time, the nature and extent of the problems at these firms may warrant higher pay for executives who were hired to replace the management teams that created the problems in the first place. Consequently, we do not believe that a one-size-fits-all policy with regard to remuneration, even for firms that received public funds, will serve the best interests of stakeholders.

5.8. Conflicts of interest

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 the markets alone is not always possible or effective.

Specific questions:

- 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?*
- 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?*

8. As a general rule, all conflicts of interest should be avoided as far as possible. When this is not possible they should be reduced to a minimum and fully disclosed to investors, the supervisory authority and other stakeholder groups. Surveillance of conflict of interests cannot be left to the market (i.e. investors) alone. At the same time, managing these conflicts must remain the responsibility of management and boards by virtue of their direct involvement on a day-to-day basis. Outsourcing management of such matters, either through direct involvement by competent authorities in their oversight and management capacity or through



indirect oversight by prescribed rules, would not eliminate such conflicts. However, it could make the solutions to the problems more bureaucratic and, potentially, more difficult to manage.

Conflicts of interest are inherent in large corporations. Part of the solution is to empower investors and to encourage them to use their vested powers. It must also be clearly stated that the board has a fiduciary duty to act in the best interest of their shareholders, which in turn, requires appropriate consideration of the interests of all other stakeholders to enhance long-term value.

- 8.1. See above
- 8.2. CFA Institute has advocated a universal code of conduct, including conflict of interests rules to apply to the whole financial sector in the European Union regardless of which sectorial directive that may apply. This would remove existing loop holes and inconsistencies and at the same time create a level playing field.

1st September 2010.