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COMMENTS ON THE EBA DRAFT GUIDELINES ON INTERNAL GOVERNANCE

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We welcome the opportunity to comment on the EBA Guidelines on internal governance. We thank ESBA for providing us this opportunity. Some detailed comments about potential suggestions are included in the pages that follow.

TITLE I – ROLE OF THE MANAGEMENT BODY REGARDING INTERNAL GOVERNANCE

- **Paragraph 17** demands a written document duly approved by the management body in its supervisory function, describing responsibilities and duties of the management body. To avoid duplications, flexibility should be left to each organization as to the most appropriate instruments to formally describe the governance structure of each institution. This could, for instance, take the form of one document encompassing all governance matters, or separate, but coordinated, documents addressing the functioning of the management body or all the internal control functions. According to several domestic regulations, the institutions are already obliged to draw a very comprehensive document to be approved by the management body in its supervisory function. For instance, in Italy such a document describes tasks and responsibilities of all the actors of the organization, from the role of the head of the management body in its supervisory function and management function, to the top management including the key managers. Please refer to paragraph 70 related to the adoption of a governance policy for similar considerations.

- **Paragraph 19.c** expounds the management body's responsibilities, among which are the implementation of an adequate, effective and independent internal control framework which should include internal control functions that have "*sufficient... stature.*"
  No definition of the term *"stature"* is offered. The term "*stature*" used in the Guidelines should mean that the person shall have sufficient technical competence, experience, managerial skills, and integrity.

- **Paragraph 19.h** requests an interaction between committees and competent authorities and other interested parties. We found the wording in this paragraph somewhat unclear. In particular, it is not clear whether Paragraph 19.h envisages a flow of information between the management body or its committees to the competent authorities. We believe that each institution should be allowed to decide which is the most appropriate body to ensure an effective information flow to the competent authorities, taking into account the specific organizational structure of the institution, the requirement to safeguard the information flow from conflict of interests, and local legislation for instance, in Italy certain information duties are specifically attributed by operation of law to the board of statutory auditors (*collegio sindacale*). In most cases, the appropriate counterparty to an authority should be the management body rather than a committee. The expression "*other interested parties*" calls for further clarification, for instance, does this include shareholders too?

- **Paragraph 19.j** provides the management body with the duty to include, set, approve and oversee the implementation of corporate culture and values. The paragraph uses both the term "*values*" and the term "*culture*". While the term "*values*" is generally accepted to refer to ethical conduct, the term "*culture*" seems to be broader and include elements that go beyond ethics, *e.g.* entrepreneurship or innovation.
  If the terms "*culture*" and "*values*" are indeed intended to have different meanings, then their respective meanings should be explained. Otherwise, it would be sufficient to use the word "*values*", which would also be more consistent with the reference to the code of conduct in Paragraph 19.j. From a purely formal perspective, our suggestion is that the

Guidelines should replace the word *"including"* with *"such as,"* and by adding the code of conduct as a possible reference.

- **Paragraph 19.k** deals with the integrity of accounting and financial reporting systems. It is not clear in the Guidelines whether duties and responsibilities of the management body in this domain are tasks of the management body in its supervisory function or in its management function.

  The solution adopted by each bank should be mindful of any restriction or standard imposed by local legislation. For instance, in Italy there is a large set of specific legislation (*e.g. Disposizioni per la tutela del risparmio* L. 262/2005), which clearly identifies tasks and responsibilities.

- **Paragraph 23** provides for the duty of the management body in its supervisory function to "*ensure*" the integrity of the financial information and reporting, and of the internal control framework, including effective and sound risk management. The choice of the word "*ensure*" appears unrealistic for the management body in its supervisory function. It should be considered whether the obligation of the management body in its supervisory function shouldn't instead be that of adopting the appropriate instruments (*e.g.* internal control functions, appropriate policies, adequate resources) to ensure that the institution is adequately equipped to safeguard integrity of the financial reporting system.

- Similarly, **Paragraph 24.g** concerns the expression "*ensure*". This provision states that the management body needs to ensure that the heads of internal control functions are able to act independently. The concept of independence is not sufficiently clear, as an explanation of specific standards of independence is missing. The concept of independence of the heads of internal control functions should be clarified.

- **Paragraph 33** provides that the management body in its management function should report "*without delay*" to the management body in its supervisory function. The words *"without delay"* are open to interpretation. For instance, it could be interpreted either as a duty to inform the management board in its supervisory function at the next scheduled

meeting or as an obligation to convene an *ad hoc* meeting. It should be considered whether the management body in its supervisory function should take into account the materiality and urgency of the matter. Reference should be made to a concept of "*appropriateness*" or necessity.

Thus, our proposal is to replace the term "*without delay*" with "*when appropriate*" or "*necessary*," which, in our view, fulfills proper corporate governance needs.

- Some concerns are raised with reference to **Paragraph 37**, which contemplates among other aspects, the composition of the committees and the necessity to avoid the "overlapping" of members.This suggestion might not be in line with the proportionality principle as set forth by EU law. In our view, an overlapping is uncommon in large institutions in which it is reasonable to have a wider number of board members so that different tasks can be assigned to different people. This should not be the case for small and medium size institutions which, from a proportionality principle view, do not have the need to assign each single task to a single member. Thus, overlapping might be a common consequence without compromising sound governance.

  Our proposal is to mitigate the concept of avoidance of overlapping by making reference to the proportionality principle.

- **Paragraph 46.a** defines the direct interaction between risk and nomination committees and the relevant corporate and control function. While the "rationale" for this provision is clear, the way this provision is drafted could create a significant degree of duplication and confusion within the corporate organization.

  Other than for the specific role of internal control functions in connection with their duties *vis-à-vis* the management body in its supervisory function and its committees, we believe that the normal channel of communication between the committees and the corporate functions should be the management body in its management function. Therefore, the committees should ask the management body in its management function for the information and direct the request for information to the corporate functions only

if the management body does not provide satisfactory information or, in special circumstances, should not be involved in the information flow (*e.g.* because of an actual or potential conflict of interest).

- **Paragraph 47.e** provides that the risk committee should review the proposed appointment of external consultants chosen by the supervisory function. It is unclear why these committees should review such appointments.
  If the intention is to ensure independence of the external consultants, then the provision should indicate in what circumstances the risk committees' review is necessary.

- **Paragraph 49** provides the necessary participation of the risk committee in the meetings of the remuneration committee.
  In our view, the Guidelines should specify that the necessary participation of the risk committee in the meetings of the remuneration committee should be limited to the matters of mutual interest.

TITLE II – INTERNAL GOVERNANCE POLICY, RISK CULTURE AND BUSINESS CONDUCT

- **Paragraph 70** concerns the definition and adoption of the governance policy by the management body to implement a clear organizational and operational structure.
  As already explained in Paragraph 17, according to us, the institutions should not be obliged to draft a specific document for this purpose. Our suggestion is that the Guidelines should specify that a governance policy may not only be contained in one specific document but be considered through a unitary vision of all institutional internal sets of documented rules related to corporate governance adopted by institutions.

- According to **Paragraph 77** the consolidating institution should *"ensure that the institutions and entities within the group comply with all specific requirements in any relevant jurisdiction."* The use of the word "*ensure*" seems to imply that the consolidating

institution has an obligation to ensure a result. This would not be realistic and could create moral hazard by sending the message to the management bodies of the institution's subsidiaries that the responsibility to comply with all specific requirements of their jurisdiction lies primarily with the consolidating institution. Also, a provision of this nature could facilitate the exposure of the consolidating institution to litigation for violations committed by the subsidiary, thus resulting in a *"piercing of the corporate veil."* An alternative approach could be to say that the consolidating institution should ensure that the institutions and entities within the group have access to sufficient resources to comply with all specific requirements in any relevant jurisdiction.

- **Section 9. 3 Conflicts of Interest**

  The definition of "conflict of interest" may vary from jurisdiction to jurisdiction. The Guidelines should either provide a precise definition of conflict of interest, or specify that the term should be construed on the basis of local law.

- **Paragraph 92** provides the content of a written policy on conflicts of interest. The legislation of certain countries may already have provisions regulating conflicts of interests and/or specific situations of conflicts of interests, such as transactions with related parties. It would be advisable to specify the policy referred to in Paragraph 92 need not cover those situations that are otherwise covered by provisions of law or *ad hoc* internal regulations.

- **Paragraph 95** provides that a statement as to how the conflict of interest has been mitigated or remedied needs to be issued. This provision calls for a further clarification, since no explicit reference is made on the addressees of the "statement" regarding how the conflict of interest has been mitigated or remedied. Potential addressees could be the banking authority or the public.

- **Paragraph 103** While the provision only indicates that the institutions may "*consider*" a member of the management body in its supervisory function responsible for the internal

governance policy and procedures, it is likely that this provision will be interpreted as a preference of the regulator. It would be preferable to say that institutions should consider what is the most effective organization to ensure and oversee the integrity, independence, and effectiveness of the institution's internal alert policies and procedures. This would oblige the institutions to make an assessment of their specific risk profile and requirements and identify the most appropriate person/function to cover that role (who may, or may not be a member of the management body).

TITLE III – PROPORTIONALITY

- **Paragraph 111** states broad criteria that institutions should take into account when developing internal governance arrangements. It should be considered whether some further guidance could be given by the Guidelines to help institutions in identifying the appropriate elements to assess their position. For instance, reference could be made to financial or balance sheet thresholds or categories of risk, or the Guidelines could mandate the national authorities the identification of more specific criteria.

TITLE IV – INTERNAL CONTROL FRAMEWORK

- **Paragraph 113** rightly states that the internal control functions should include compliance, risk management, and audit, thus suggesting that there are other functions that should be regarded as having a role in internal controls. The Guidelines could consider being more explicit, *e.g.* say that the management body should assess what internal control functions are appropriate given the peculiarities of each institution and its business, and state that in any event the internal control functions should include compliance, risk management, and audit. The management body should also consider whether any such additional internal control function should have direct access to the

management body and/or other safeguards of its independence. This approach would be consistent with the G20/OECD Principles of Corporate Governance (VI.D.6).

- At **Paragraph 116** a more flexible approach is recommended, as some of the duties mentioned in this paragraph (*e.g.* establishing the internal control system) appear to be for the management body in its management function while others (*e.g.* monitoring the adequacy and effectiveness of the system) are more appropriate for the management body in its supervisory function.

- **Paragraph 119** provides that the *internal control functions* should verify that internal control policies, mechanisms and procedures are correctly implemented. To avoid confusion and duplications, the Guidelines could consider adding that each of the internal control functions will be in charge of verifying the area subject to the responsibility of that function.

- **Paragraph 124** states that *"for significant institutions, competent authorities should be promptly informed about the reasons of appointment and removal of a head of an internal control function."*

  Our concern is limited to the obligation to provide information to the competent authorities in connection with removal scenarios. An institution may decide to separate itself from an employee for a number of reasons, including reasons that may be disputed by the employee. For instance, the institution may have lost trust in the individual because of the individual's behavior, but not be in the position to successfully defend a case. Particularly in jurisdictions where employment law is highly protective of the position of the employee, the institution and the employee often decide to reach an amicable settlement of their differences, and a condition of the settlement is that the institution is obliged to keep confidential the terms of the separation agreement, or the parties agree on a statement as to the reasons why the employee is leaving (*e.g.* with reference to the employee's desire to pursue new professional challenges, or spend more time with his/her family, or pursue personal interests). As obviously the information to

be provided to the competent authorities would have to be truthful, this could create a tension between the arrangements made with the departing employee and the requirement to provide the correct information to the authorities. An alternative way to address this problem would be to limit the institution's obligation to informing the authority that the head of an internal control function has been appointed or removed. The authority could then ask the institution to provide the reasons for the appointment/removal, and the institution would be obliged to respond, irrespective of any confidentiality undertaking it may have given the employee.

- **Paragraph 128** sets forth that even when internal control operational tasks are partially or fully outsourced, the head of the internal control function concerned and the management body are still responsible.
  Our standpoint is that a difference should be drawn between the intragroup outsourcing and outsourcing to third parties.

- **Paragraph 180** states that the compliance function "[…] *should ensure that compliance monitoring is carried out through a structured and well-defined compliance monitoring programme* […]." Concerns have been raised with reference to the compliance monitoring programme. The wording of the Guidelines appears to be ambiguous. The compliance monitoring programme could be confused with other documents already adopted (*e.g.* the risk assessment plan) if no further specification is provided by the Guidelines.
  We suggest to determine in a clear way the requirements of the compliance monitoring programme and to clarify whether a specific document has to be adopted if other documents already fulfill the same requirements.
  This paragraph sets forth that "*the compliance function should* […] *report to the management body*." We suggest that the Guidelines specify whether the compliance function should directly report to the management body in its supervisory or in its management function, or clearly state that each institution has to make that determination.

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TITLE V – TRANSPARENCY

- According to **Paragraph 201**, written guidelines, manuals, or other means may be produced in order to grant the implementation of the enduring information and update of the relevant staff.

  Our suggestion is that EBA Guidelines should specify that a governance policy may not only be contained in one specific document, but be considered through a unitary vision of all internal rules related to corporate governance, taking into account any local requirements.

CLOSING REMARK

We appreciate the work of the EBA on internal governance.

The last few years have seen a proliferation of measures and guidelines by various bodies such as the ECB, EBA, ESMA. These measures occasionally appear not to be fully coordinated; we believe that institutions and other market players would appreciate an additional effort to coordinate among the relevant regulators.

Best regards,

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of PAUL HASTINGS (EUROPE) LLP