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An Analysis of the Walker Review of Corporate Governance in U.K. Banks and Other Financial Institutions

TIHIR SARKAR, SIMON JAY, AND GARRY MANLEY

The British government recently published the final version of the independent review of corporate governance in U.K. banks and other financial institutions conducted by Sir David Walker at the request of Prime Minister Gordon Brown. This article analyzes the recommendations made in the review in light of subsequent developments, and considers the extent to which the review will affect listed entities that are not banks and other financial institutions.

As a result of the global financial crisis that commenced with the onset of the U.S. sub-prime mortgage crisis in 2007, the United Kingdom's Prime Minister, Gordon Brown, commissioned an independent review of corporate governance in U.K. banks and other financial institutions ("BOFIs") in February 2009. The initial draft of the review, which was led by Sir David Walker (the "Draft Review"), was published in July 2009. Following a period of consultation on the Draft Review (the "Consultation"), Her Majesty's Treasury published the review (the "Review") on November 26, 2009.[1]

The Review proposes that the majority of the recommendations made in the Review (the "Recommendations") be enforced through inclusion in the Combined Code on Corporate Governance (the "Combined Code"). It

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Tihir Sarkar and Simon Jay are partners in the London office of Cleary Gottlieb Steen & Hamilton LLP. Garry Manley is an associate in the firm's London office. The authors can be reached at tsarkar@cgsh.com, sjay@cgsh.com, and gmanley@cgsh.com, respectively.

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would be for the Financial Reporting Council (the "FRC"), which has been closely consulted during the course of the Review, to decide exactly how this would be done. The FRC — which has been conducting its own biennial review of the impact and implementation of the Combined Code concurrently with the Review — published its final report (the "FRC Final Report"),[2] together with a revised draft of the Combined Code,[3] which is to be renamed "The U.K. Corporate Governance Code," and a consultation document thereon, on December 1, 2009. The changes set out in the draft U.K. Corporate Governance Code were fairly modest, however, and the extent to which the Recommendations are incorporated into the U.K. Corporate Governance Code will therefore depend on the outcome of the FRC's ongoing consultation, which ends on March 5, 2010.

The Review also recommends separating out the provisions of the Combined Code that relate to institutional shareholders into a new stewardship code (the "Stewardship Code"), which, like the Combined Code, would apply on a "comply or explain" basis.[4] The FRC published a draft Stewardship Code for consultation in January 2010.[5]

The Review proposes that the Financial Services Authority (the "FSA") will consider how to take forward the Recommendations that apply principally to financial institutions, and that the Recommendations on pay disclosure should be enforced through legislation in the Financial Services Bill that is currently going through Parliament.[6]

THE RECOMMENDATIONS

The Review examines five key areas and makes 39 Recommendations. The key Recommendations are summarized below by reference to the five key areas examined by the Review.

1. Board size, composition and qualification

The Review focuses on the actions of BOFI boards, rather than their size or organization. The Recommendations in this area have been relaxed as a result of the Consultation, and the application of a number of the Recommendations has been limited to FTSE 100-listed banks or "major banks" — a term that

is used frequently, but not defined, in the Review — rather than all BOFIs. The Review recommends that the overall time commitment of nonexecutive directors ("NEDs") as a group on the boards of FTSE 100-listed banks or life assurance companies should increase. Although the Review provides that the manner in which a particular board achieves this object will depend on the composition of the NED group on the board, it expressly recommends that, in the case of a major bank board, a minimum time commitment of 30 to 36 days a year — up to 50 percent greater than the current average of 20 to 25 days — should be clearly indicated in the letters of appointment of "several NEDs." Where so substantial a time commitment is not "envisaged or practicable" for particular directors, the Review indicates that the letter of appointment (which should be available to shareholders) should specify the time commitment agreed between the individual and the board.

Above all, the Recommendations in this area focus on the need to ensure that there is a knowledgeable and competent group of independent NEDs capable of questioning and challenging the decisions of the executives. Walker has said that "alongside the necessity for financial expertise, nonexecutives, particularly chairmen, must be strong characters," adding that "financial expertise is meaningless without an atmosphere of challenge." The Review emphasizes the need for BOFI NEDs to have financial industry experience and increased education and support, to enable them to engage in a pro-active manner in board deliberations, above all on risk strategy. It stresses that "independence of mind," together with financial industry experience, is more likely to be able to bring effective and constructive challenge to the board's deliberation process than the formal appearance of independence. In a move that will surprise some corporate governance experts, the Review also expresses the view that the prohibition on CEOs stepping up to the chairman's role could be lifted, although Walker stops short of recommending a corresponding amendment to the Combined Code, noting instead that, where such an appointment is made and a clear justification is provided, shareholders and fund managers should interpret the Combined Code in a flexible manner.

2. Functioning of the board and evaluation of performance

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

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

The chair of a major bank should be expected to spend not less than two-thirds of his or her time on that role, with the clear understanding that it would take priority over any other business commitments in the event of need. Walker has explained separately that this requirement will mean that, in practice, such chairmen cannot chair other companies. Following the Consultation, however, this requirement no longer extends to all BOFI chairmen. The relevant Recommendation states that, depending on the balance and nature of their business, the required time commitment should be "proportionately less" for the chairman of a "less complex or smaller bank, insurance or fund management entity." The Review also proposes that the chairman of a BOFI board should be proposed for election annually, and that the board should keep under review the possibility of requiring the annual election of all board members.

The Review recommends that NEDs should be ready and encouraged to challenge and test the executive board's strategy proposals, and that the board should be required to evaluate its performance every two to three years, with the assistance of external advisers, and to summarize this evaluation in the annual report.

3. The role of institutional shareholders: communication and engagement

The Review recommends that institutional shareholders should take a more active role in their portfolio companies since, according to Walker, "[they] enjoy the privilege of limited liability whereas taxpayers have ended up assuming unlimited liability in respect of the big banks. Early preventive medicine through shareholder engagement can save everyone substantial time

and money later on." The Review also proposes extending the FRC's remit to encompass the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. The Review provides that the FRC's new role should be clarified by separating the content of the Combined Code from the newly proposed Stewardship Code, and recommends that the FSA should require institutions that are authorized to manage assets for others to disclose clearly on their websites or in other accessible form the nature of their commitment to the Stewardship Code or their alternative business model. In the FRC Final Report, the FRC agreed to take on this new responsibility, subject to consultation designed to ensure that the Stewardship Code can be operated effectively. As recommended in the Review, the FRC's consultation on the Stewardship Code takes the Code on the Responsibilities of Institutional Investors published by the Institutional Shareholders' Committee in November 2009 as the starting point for the consultation.

The Review also recommends the publication of the voting records of fund managers and other institutional investors.

4. Governance of risk

As with other areas of the Review, a number of the Recommendations in this area have been relaxed as a result of the Consultation, and the application of a number of the Recommendations has been limited to FTSE 100-listed banks or "major banks." The Review recommends the creation of board risk committees, separate from audit committees, to oversee the activities of the boards of FTSE 100-listed banks and major banks and advise them on their current risk exposure and future risk strategy. The risk report of the board risk committee (or board) should be included in the annual report and accounts. While a number of BOFIs already have a board risk committee in place, the Review goes further by recommending that BOFI boards should have an independent chief risk officer (the "CRO"), who should participate in risk management at the highest level on an enterprise-wide basis, and whose removal from office would require the prior agreement of the board. The CRO should report to the board risk committee, with direct access to the chairman of the committee, if required. The Review recommends that the

board risk committee should ensure that due diligence is undertaken before the board decides whether to proceed with proposed strategic transactions involving an acquisition or disposal.

5. Remuneration

In relation to the Draft Review, Walker stated that the Recommendations relating to remuneration were "as tough, or tougher, than anything to be found anywhere else in the world." In reality, however, many of the Recommendations in this area do not add much to the requirements set out in the FSA's Remuneration Code (the "Remuneration Code") that already applies to many FSA regulated firms. Walker's Recommendations on remuneration have been widely accepted by the financial services community, and were somewhat overshadowed by Alistair Darling's announcement, in his Pre-Budget Report on December 9, 2009, of a bank payroll tax, payable by banks on 50 percent of each bonus to which a banking employee is entitled, to the extent that such bonus exceeds £25,000. Although the Review stops short of proposing that levels of remuneration should be capped, the Recommendations, if implemented, would require, among other things:

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

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

- Executive board members and High End Employees in a BOFI that is included within the scope of the Remuneration Code to have their remuneration spread over five years, with half of their variable remuneration in the form of a long-term incentive scheme with vesting subject to a performance condition — half should vest after not less than three years and the remainder after five years — and short-term bonuses should be paid over three years, with not more than a third in the first year. The Review recommends that this structure should be incorporated in the Remuneration Code review process, and that the remuneration committee report of a BOFI for the 2010 year of account and thereafter should indicate, on a "comply or explain" basis, the extent to which an entity's remuneration arrangements conform with this structure;
- The remuneration committee report to disclose whether any executive board member or High End Employee has the right to receive enhanced benefits beyond those already disclosed in the directors' remuneration report; and
- Remuneration committee chairmen to stand for re-election if the remuneration committee report attracts less than 75 percent investor support.

IMPACT ON NON-BOFI U.K. LISTED ENTITIES

The Review concludes that the "comply or explain" approach of the Combined Code, combined with tougher capital and liquidity requirements and a tougher regulatory stance from the FSA, remains "the surest route to better corporate governance practice, with some additional BOFI-specific el-

ements to be taken forward through the FSA." Although the Recommendations address the governance of BOFIs only, Walker has made it clear that, in his opinion, the Recommendations should be applied to all U.K. listed entities. Commenting on the Draft Review, Walker has stated: "The risk elements are bank specific, but much of the rest of it could be applied to any other company. Why wouldn't the challenge element apply to…anyone else?" While recognising that "the relevant guidance and provisions require amplification," the Review's only proposal for new primary legislation relates to the mandatory disclosure of remuneration of High End Employees.

Since the remit of the Review was limited to the governance practices of BOFIs, the extent to which the Recommendations will eventually apply to non-BOFI listed entites remains to be seen. Much will depend on the extent to which the FRC incorporates the Recommendations into the U.K. Corporate Governance Code, and whether or not the FRC's revisions are applied merely to BOFIs or to all companies that are required to comply with the U.K. Corporate Governance Code. It is currently anticipated that the final U.K. Corporate Governance Code would apply to financial years beginning on or after June 29, 2010.

NOTES

[1] Available at: http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

[2] Available at: http://www.frc.org.uk/images/uploaded/documents/2009%20Review%20of%20the%20Combined%20Code%20Final%20Report1.pdf.

[3] Available at: http://www.frc.org.uk/images/uploaded/documents/Consultation%20on%20the%20Revised%20Corporate%20Governance%20Code1.pdf.

[4] Under the Listing Rules, the Combined Code applies on a "comply or explain" basis to all companies incorporated in the United Kingdom with a listing on the Official List of the U.K. Listing Authority. Companies incorporated outside the United Kingdom that have a primary listing are simply required to disclose whether or not they comply with the corporate governance regime of their country of incorporation and the significant ways in which their corporate governance practices differ from those set out in the Combined Code. Proposed changes to the Listing Rules will however result in a change in the requirement to adopt the Combined Code.

[5] Available at: https://www.frc.org.uk/images/uploaded/documents/Stewardship%20Code%20Consultation%20January%2020101.pdf.

[6] The Financial Services Bill 2009-10 had its first reading in the House of Lords on January 26, 2010. At the time of writing, the second reading was due to be held on February 8, 2010.