SWEDISH
CORPORATE
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**Comments regarding Ministry of Finance Report on stronger capital requirements rules (SOU 2013:65)**

The Swedish Corporate Governance Board (the Board) was invited to comment on the report on stronger capital requirements rules, and the Board's opinions are summarised below.

## 1 Introduction

The Swedish Corporate Governance Board's rules are designed for Swedish and foreign companies whose shares or depositary receipts are traded on a Swedish regulated market. The current EU Directive (CRD 4) is aimed at banks and financial institutions. The Board believes, however, that it has sufficient reason to submit comments on the report. The shares of several banks are traded on a regulated market and banks thus represent a subset of the Board's target group. Furthermore, there is an obvious risk that the corresponding rules for banks and financial institutions will also overlap with the regulatory framework for listed companies in general. Parts of the currently proposed rules, such as limitation of the number of directorships an individual may have, will also directly affect the directors of any listed company who also have a seat on the board of a bank. On 17 August 2011, the Board also submitted comments to the government on the EU Commission's draft CRD 4 proposal. These comments can be found on the Board's website.

The Board has limited its comments to matters pertaining to corporate governance, i.e. the issues discussed in Chapter 8 of the report. The Board has not commented on the proposals on risk management and remuneration contained in Chapter 8. The proposals on sanctions against individuals also impact the corporate governance of financial institutions, and therefore the Board has also commented on the issues addressed in the chapters 11 and 13 of the report.

As the committee proposes in Chapter 8 that the issuance of corporate governance rules be delegated to the Swedish Financial Supervisory Authority, the Board's views on the directive are largely critical in order to attempt to influence the Authority in its future regulatory work.

## 2 Corporate Governance

CRD 4 contains a number of provisions on corporate governance. The provisions are largely an attempt by the European Commission to bring about good judgment and behaviour on the part of directors, which the Corporate Governance Board considers to be both inappropriate and in some cases potentially damaging for the institutions and their owners.

Today, there are rules for management assessment, which give the competent authority the right to assess the suitability of directors. It is proposed that these be supplemented by legal provisions that allow the authority to take into account the board's collective expertise when assessing the suitability of an individual director. The committee also proposes that the Financial Supervisory Authority issue more detailed regulations to meet the requirements of parts of Article 91 of the Directive. This is commented on in more detail below.

The Corporate Governance Board has no particular opinion as to what requirements are appropriate for the suitability of individual board members of financial companies. Such financial market regulation - that the Financial Supervisory Authority is to ensure through its assessment that individuals who for any reason are deemed unsuitable may not be involved in the running of a financial company - lies outside the Board's remit. However, when requirements go beyond a certain limit, they impact the corporate governance system. If the Authority’s task is no longer to screen out unsuitable people according to a set of objective criteria, but instead is tasked with ensuring that both individual directors and the board as a whole is sufficiently competent and experienced etc, the Authority has taken over one of the main roles of the owners of the company. A fundamental aspect proprietary rights is the ability to appoint the people who are to manage one's assets, given that it is the owner who bears the ultimate risk for the failure of the board. If the State, represented by the Financial Supervisory Authority, is given the task of not only assessing the appropriateness of individual directors, but also the company board's collective competence and experience, the state should as a consequence also be required to shoulder the responsibility if the owners suffer any damage should the board turn out not have sufficient competence or experience.

The Swedish Corporate Governance Board's conclusion is partly that Sweden should implement as few rule changes as possible through law or Authority regulations as a result of the directive's corporate governance provisions, and partly that the Financial Supervisory Authority in the exercise of its rights under the directive in these matters should act as restrained as possible.

### 2.1 The director’s general suitability etc.

It is not proposed that the general requirements contained in Article 91 (1) of the directive, that members of the board are to be of sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties, like the requirement in Article 91 (2), that directors are to devote sufficient time to the performance of their duties for the

institution, lead to any changes in the current Swedish rules. The same applies to the requirement contained in Article 91 ( 8), that each member of the board is to act with honesty, integrity and independent thinking in order to be able to effectively assess and challenge executive management decisions if necessary and effectively control and monitor management decision making. It can also be assumed that the general rule in Article 91 (3), that the number of executive or board assignments of a director may have at the same time depends on the circumstances of each case and the nature, scale and complexity of the institution's operations, is not considered to require special detailed regulation by the Authority.

According to the committee, these requirements are already covered by applicable suitability requirements for directors under the auspices of the management assessment process. The Corporate Governance Board agrees with the committee's conclusion that new rules from the Authority are not required.

### 2.2 The company board's combined experience etc.

According to Article 91 (1), the composition of a company board is to adequately reflect sufficiently broad experience. Article 91 (7) states that the board is to have sufficient knowledge, skills and experience to be able to understand the business and operations of the institution, including the main risks.

The report proposes that the provisions on management assessment be expanded to allow the Financial Supervisory Authority to also take into account the above-mentioned requirements for the board's collective competence when assessing the suitability of individual members, see the proposed new Chapter 3, Section 5 of the draft amendment to the Banking and Financing Business Act (2004:297).

According to the Swedish Corporate Governance Code, (the Code), the nomination committee is to ensure in its proposal that the board of the company has an appropriate composition, characterised by diversity and breadth of director competence, experience and background, see Rule 4.1. The nomination committee is also to issue a statement explaining its proposal of candidates to the board, see Rule 2.6 of the Code. The position of the Corporate Governance Board, in accordance with what is stated in section 2 above and in this section, is that this type of regulation, which shifts one of the owners' primary duties to the Financial Supervisory Authority, should not be introduced into Swedish law.

### 2.3 Number of board assignments

Limitations to the number of assignments that a member of the board is to be allowed to have are outlined in Article 91 (3)-(6). It is proposed that these rules be implemented through regulations issued by the Financial Supervisory Authority.

The Corporate Governance Board does not believe that it is possible to establish a generally

appropriate limitation to the number of assignments a director may have. Obviously, it is important that directors devote sufficient time to their task, but to introduce a specific rule for the number of other directorships or management positions is both unnecessary and administratively cumbersome. Furthermore, no factors other than certain other directorships are factored into this equation - a person may well be engaged in other matters, have assignments or other employment or have family or hobbies that take up much of her or his time. Also, how much time a person needs to spend in order to perform with a certain task is an individual matter. This is the main reason why the Code only contains a requirement that directors are to devote sufficient time to their work, without any detailed limitations of the kind currently proposed.

According to Article 91 (6), the Financial Supervisory Authority is to be able to grant permission in individual cases for a director to have an additional assignment. It is questionable how the Authority would be able to investigate in any meaningful way whether the conditions are met - Article 91 (3) states that the individual circumstances are to be taken into account by the regulator. It is the responsibility of the chair of the company board to ensure that all the directors devote the necessary time to the work of the board, and this should then be followed up in the board's evaluation of its work. In the Swedish model, it is the nomination committee which will then decide whether the director is to be proposed for re-election or not.

The way directive rule is designed, it is not even limited to the financial sector – a director's board assignment for a bank, for example, also impacts whether they would be available for board assignments in other commercial businesses, such as in listed companies. If the number of potential assignments is limited in this way, it will cause problems mainly for small and medium-sized listed companies when positions on the boards of these companies are rejected by directors who can no longer sit on the boards of many companies. That some directors have sat on the boards of many companies has been essential for newly acquired experience and knowledge to spread quickly in the Swedish corporate sector. Another consequence of the proposals presented by the Commission, of which numerical restriction is a part, may very well be that competent directors choose not to accept assignments in banks and other financial institutions.

In a larger perspective, numerical restrictions compromise the Swedish corporate governance model's division of responsibility and tasks among the owners, the board and the executive management. If the number of assignments is restricted, this will inevitably lead to demands for higher remuneration from a large number of professional directors, which in turn has an impact on the work expected of directors. This will result in boards becoming more operational than is the case today, and they will thus impinge on the operational management's work and responsibilities, with the danger of a shift in the direction of the board in these matters. This could seriously upset the balance that exists today between the board's supervisory role and responsibilities and those of the executive management.

In the view of the Corporate Governance Board, there should be careful consideration given to whether restricting the number of assignments could be conducted through a general regulation that the Financial Supervisory Authority is to consider whether an individual company director is likely to be able to devote sufficient time to her or his assignment when it conducts its suitability assessment, rather than introducing a rule on numbers and exemptions. The Authority's suitability assessment would naturally take as its starting point the nomination committee's assessment, i.e. if the nomination committee has proposed candidates to the board, there is no reason for the Authority review that assessment.

### 2.4 Training of directors

According to Article 91 (9), institutions are to allocate adequate human and financial resources to the orientation and training of members of the management body. This rule, as it is understood, will be implemented by the Financial Supervisory Authority.

In the view of the Corporate Governance Board, it is the responsibility of the company board, its chair and the individual directors to ensure that each director receives proper orientation and training to be able to carry out their work in the best way. This is an individual matter, which must be determined in the light of each director's prior experience and training, competence and other purely individual characteristics. A regulation from the Financial Supervisory Authority should not deny a board the right to decide over training resources for the purposes specified.

### 2.5 Diversity policy

Article 91 (10) requires nomination committees to consider a broad set of characteristics, knowledge and skills when appointing directors, and therefore, financial institutions are to implement a diversity policy for the work of nomination committees.

In a recently proposed directive on the reporting of non-financial and diversity information, the European Commission submitted a proposal that listed companies are to develop a diversity policy for their boards. The Swedish Corporate Governance Board commented on this proposal in its response to the Swedish Government dated 15 May 2013 (available on the Board's website) as follows:

*According to the European Commission, a homogeneous company board selected on the basis of a certain number of criteria creates conditions for collective thinking and makes the board potentially less receptive to new ideas, which the Commission in turn claims is a problem for European stock exchange listed companies. In the eyes of the Commission, this justifies a requirement that companies produce a diversity policy for boards. The most important criteria according to the proposal are age, gender, geographical spread, (which begs the question whether this means where the individual was born, grew up, has worked previously or is currently resident), educational and background and professional*

*experience. According to the preamble of the proposed Directive, the purpose of requirement for companies to produce diversity policies is to apply pressure to companies to have more diversified boards.*

*There is no scientific evidence, either theoretical or empirical, that collective thinking and narrow-mindedness is more common in homogenously composed boards using the criteria in the proposed Directive than in those that are not composed according to these criteria, which means that the fundamental basis of the proposed Directive is deficient. In this area, the European Commission reveals a remarkable lack of insight into the responsibilities and processes. Firstly, there is no generally optimal board composition that works for every company. As every company is unique, each board needs to have a composition that is suitable for the phase of development in which the company currently finds itself. It is therefore not possible to state much more than that the board in its entirety must be as competent as possible in order to meet the needs of the company and that it must have the confidence of the shareholders, as the board is appointed to manage the property of the owners.*

*The Commission further states that a homogeneous company board will not be able to challenge or monitor the executive management in the way that a diversified board could. In order to challenge and monitor a powerful executive management team in a listed company, board members need knowledge and integrity. The knowledge required is often acquired through active service in the executive management of companies of a similar size or strength. In many cases, people who have previously worked in executive management make the best board directors when it comes to challenging the Chief Executive Officer, whereas directors with other backgrounds may find it more difficult to see through the information they receive from the management. A completely diversified company board according to the criteria set by the European Commission would instead be at greater risk of being too reliant on the company management.*

*It must be the task of the shareholders in each individual case to appoint the board that they at that time regard as the most suitable to lead the company. It should be emphasised that the owners of a company have a strong interest in choosing board directors who will safeguard and promote the interests of the shareholders. During the selection and appointment process, shareholders must consider the different risks associated with different constellations, and the possible danger of collective thinking is just one of a range of risks and possibilities. This work must be conducted every time a board is appointed, and it cannot be decided in advance. Mandatory requirements on shareholders to determine a diversity policy mean that previous shareholders will force a certain type of board composition on current shareholders.*

*Sufficiently strong rules requiring consideration of aspects of diversity when appointing board directors already exist, as well as information requirements concerning the*

*composition of boards. Rule 4.1 of the Swedish Corporate Governance Code ("the Code") states:*

> *"The board is to have a composition appropriate to the company's operations, phase of development and other relevant circumstances. The board members elected by the shareholders' meeting are collectively to exhibit diversity and breadth of qualifications, experience and background. The company is to strive for equal gender distribution on the board."*

*Code rule 2.6 states that the nomination committee is to explain its proposals regarding the board of directors, especially with regard to the requirements contained in Code rule 4.1, on the company's website no later than the date of issue of the notice of the shareholders' meeting.*

*In addition to requirements to include information on board composition etc contained in the Annual Accounts Act, the Code requires publication of the following information on each member of the company's board both before board elections and in the annual corporate governance report (Code rules 2.6 and 10.2)*

- *The candidate's age, principal education and work experience*
- *any work performed for the company and other significant professional commitments*

*On the issue of diversity and collective thinking, it is therefore the considered opinion of the Swedish Corporate Governance Board that no requirement for companies to produce and disclose a diversity policy should be introduced.*

For the reasons stated above, the Swedish Corporate Governance Board is also opposed to the introduction of a requirement for financial institutions to produce binding diversity policies for their boards.

### 2.6 Establishment of a nomination committee within the board

The Swedish Corporate Governance Board agrees with the assessment that the rules on nomination committees in Article 88 (2) of the directive do not need to be incorporated into Swedish law, as a Swedish company board has no control over the selection and appointment process of directors.

## 3 Administrative financial penalties for individuals

The Committee's proposals for implementation of the sanction provisions contained in the directive include giving the Financial Supervisory Authority the right to impose administrative financial penalties on individuals in the management of the institution if the institution breaches regulations. Liability can be assigned where the Authority finds that there are specific reasons for such a sanction. Some form of breach against accepted behaviour

must have been committed by the individual, but the proposal does not go into more specific detail than so, nor does it contain any requirement regarding subjectivity criteria on the part of the director. The sanction can be as much as five million Euros or up to twice the profit earned or the costs avoided by the breach. According to the proposal, the decision on the level of the fee payable is to be made by the Authority and not in any form of independent process subject to examination by both sides. A decision can normally be executed immediately, unless inhibition is sought and granted.

As this rule stands, the Financial Supervisory Authority FSA would issue the regulations, exercise their supervision and impose sanctions on individuals. This means that the Authority would act both as investigator, prosecutor and judge. This poses a clear danger of conflicts of interest, partiality and that the sanctions system becomes legally unsound.

In a sound legal system, financial sanctions against individuals of the magnitude stipulated by the directive must be dealt with in a court of law. The directive does not put any obstacles in the way of such a solution. One of the main arguments for the current system of financial penalties is that it requires speed when intervening against individual institutions. That argument, however, has no bearing with regard to fines for individual board members.

A further aspect is that the processing of sanctions and how they are decided should be analysed on the basis of the Supreme Court's *ne bis in idem* verdict of 11 June 2013, which means that the right not to be punished twice for the same offence (act) includes the system of penalties and sanctions for violations of criminal tax law. This can also apply to an administrative sanctions system within the field of financial supervision.

Therefore, the view of the Swedish Corporate Governance Board is that the proposed procedure gives rise to great concern, both in the light of the European Convention for the Protection of Human Rights and Fundamental Freedoms and Swedish constitutional principles, and in light of the consequences this may have for the governance of financial institutions.

One obvious problem with such drastic, unpredictable sanctions is the danger that recruitment to senior positions in financial institutions could become significantly more difficult. The risk of sanctions would also need to be compensated for by to a high remuneration levels to directors.

Perhaps the biggest problem, however, is the different roles of the Financial Supervisory Authority. If an institution breaches a regulation, what director will not primarily think of how to escape personal sanctions rather than acting in the best interests of the institution (and its owners and customers)? The risk that the Authority may use the threat of personal administrative financial penalties to persuade representatives of the institution to act in the way the Authority finds desirable, such as admitting institution's guilt on to some issue, is in

itself enough reason for the Swedish Corporate Governance Board to oppose the proposals in this area.

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