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Re: Thematic Inspection – Review of investment firms' Corporate Governance Standards

Dear Sir/Madam

In February 2012, the Central Bank of Ireland (the “Central Bank”) published its Programme of Themed Reviews and Inspections for 2012. During the first quarter of 2012, a cross-divisional inspection team undertook a series of themed inspections of investment firms authorised under S.I. No. 60 of 2007, the European Communities (Markets in Financial Instruments) Regulations 2007 (“MiFID Regulations”), to review and evaluate current corporate governance practices.

Effective governance of regulated entities is necessary to ensure that the interests of their clients and stakeholders are protected. The themed reviews of a sample of investment firms assessed their approach to corporate governance, their compliance with the relevant MiFID Regulations and took stock of best practice in the industry. This letter delivers on our commitment to provide feedback in relation to the findings from this inspection series.

MiFID sets out a number of high-level requirements for the corporate governance arrangements of investment firms. We found the majority of the MiFID firms inspected were cognisant of industry developments in relation to corporate governance and we observed that a number of firms have implemented best practice in this area. However, we also found that many of the firms inspected had deficient and, in some cases, inadequate corporate governance arrangements. It was evident that those firms with independent non-executive directors generally demonstrated an evolved and embedded corporate governance structure when compared against those firms who have yet to appoint independent members to their boards.



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Having analysed the findings from the Thematic Inspection Series, it is apparent that while many firms have adopted some of the principles of good corporate governance there are still areas which would benefit from further development. We would like to highlight for you those principles we feel would be beneficial to all MiFID firms. In total we have 9 recommendations which are outlined in the attached Schedule. We would request that you review your firm's corporate governance arrangements in the context of industry best practice and make any necessary changes to ensure that your firm remains consistent with its peers.

If you have any queries in relation to this letter, please contact your supervisor of this division.

Yours sincerely

Patricia Dunne

Deputy Head of Investment Service Providers Supervision

Schedule of Recommendations

1. *The appointment of independent non-executive directors has become an industry best practice in recent years. MiFID firms without an independent non-executive should challenge themselves to review their board arrangements in this regard. The outcome of this review should be documented.*

Currently all firms applying for MiFID authorisation are required to have in place at least one independent non-executive director. During the corporate governance inspection series 64% of firms were found to have appointed an independent non-executive director to their board. A number of these firms demonstrated elements of best practice including: designated board sub-committees, documented corporate governance structures, agenda preparation processes, detailed reporting at board level and sufficiently comprehensive minutes reflecting discussions and participation by board members.

Similarly, in certain instances, firms which had not appointed an independent non-executive director were found to have significant weaknesses in these areas with a lack of formalised board reporting and inadequate meeting minutes. Furthermore, these inadequacies were reflected in the informal nature of board reporting and discussions. We would encourage all MiFID firms without an appointed independent non-executive director to consider the value and benefits of such an appointment in the context of their corporate governance arrangements.

2. Non-executive directors are not independent simply by virtue of not being involved in the day-to-day management of the business. Therefore, firms must give appropriate consideration to determining if a director is independent.

During the thematic inspection series Authorised Officers noted that the process and criteria applied for determining a non-executive director's independence varied. A number of firms recognised the need for consideration of the independence of their non-executive directors due to the conflicts of interest that may arise. However, 36% of the firms identified one or more of their non-executive directors to be an independent non-executive director, despite significant shareholdings held and services provided to the firm outside of their capacity as a non-executive director.

As highlighted above independent non-executive directors can add considerable value to the board and the firm as a whole through the exercise of sound judgement and decision making which is independent of the views of management, or any other outside influence. It is essential that firms ensure that an appointed non-executive can reasonably deliver an independent perspective. Best practice observed from industry suggests the following criteria should form part of the firms' consideration when evaluating the independence of an existing or potential independent non-executive director:

- any financial or other obligation the individual may have to the firm, its associated undertakings or its directors;
- whether the individual is, or has been employed by the firm, its associated undertakings or its directors in the past, and the post(s) so held;
- whether the individual has close family ties with any of the company's directors or senior employees;
- whether the individual is a significant shareholder;
- any remuneration received directly or indirectly, by the Director in the course of providing non director services to the firm in the past or currently.

Firms that consider the independence of their directors were noted to facilitate an environment of open communication and a transparency in practices. In addition, these firms demonstrated an awareness of the conflicts of interest that could arise and arranged suitable procedures in the event of such conflicts.

3. *The role of the Chairman and CEO should be separate and where possible an independent non-executive director should be appointed Chairman.*

During a number of the inspections it was observed that the CEO also acts as the Chairman of the board. In line with developed industry best practice, firms should consider the separation of CEO and Chairman roles. The inspection series identified significant value to be gained from segregating the role of CEO and Chairman with advanced organisational arrangements and formalised board meeting processes adopted in firms with an independent non-executive chairman of the board.

4. *Decision making authority but not ultimate responsibility can be assigned to a board sub-committee. Where board sub-committees are established there should be appropriate terms of reference and reporting provisions established.*

Regulation 34(1) (a) of the MiFID Regulations states:

“An investment firm shall – (a) establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities.”

The MiFID Regulations require firms to ensure that the organisational structures and reporting arrangements implemented are captured in a documented format. 82% of firms inspected had established at least one board sub-committee. However, the formality with which these sub-committees operated varied from firm to firm. In particular, Authorised Officers noted that while firms had typically formalised a terms of reference for each sub-committee these were often silent as to the responsibilities assigned to the sub-committees and the required level of reporting to the board. Best practice arrangements were observed to include detail of: the structure of the committee, the decision making processes, and the reporting requirements including appropriate escalation to board level. This formalised structure allowed for informed decisions and high level discussion at board level and contributed to greater structure in arrangements.

5. *Corporate Governance Structures should be documented clearly and include at a minimum the role and responsibility of the board.*

Regulation 34(1) (a) of the MiFID Regulations states:

“An investment firm shall – (a) establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities.”

We would consider a documented corporate governance structure to be a fundamental cornerstone in complying with this requirement. In this regard, each firm must be able to demonstrate how it has developed and documented appropriate governance structures with clearly defined reporting lines. We noted during our inspections that this fundamental principle can often be overlooked. 36% of firms inspected were found not to have a formally documented corporate governance structure, with a further 45% having developed a documented corporate governance structure requiring further enhancements to capture best practices.

Although firms were able to describe their corporate governance arrangements, few have significantly documented these arrangements formally. The firms that have formally documented their corporate governance structures and arrangements demonstrated developed internal structures and reporting arrangements with the board retaining ultimate responsibility for oversight. Furthermore, firms that then circulated the corporate governance structures to their staff exhibited a significant understanding of the reporting lines and arrangements implemented. Equally in certain instances, firms which have not developed or formally documented their corporate governance arrangements displayed deficient reporting arrangements, a lack of awareness and ownership of activities and in certain cases a lack of oversight by the board.

Industry best practice development in this area would suggest that there is room for further adoption of documented corporate governance arrangements across the MiFID firm population.

- 6. All fundamental board reporting should be in writing and should be sufficiently comprehensive so as to inform an independent reviewer. Board minutes should be sufficiently detailed to reflect active discussions and participation of attendees.***

Regulation 34(1)(e) of the MiFID Regulations states:

“An investment firm shall – (e) establish, implement and maintain effective internal reporting and communication of information at all relevant levels of the investment firm.”

Regulation 34(1)(f) of the MiFID Regulations states:

“An investment firm shall – (f) maintain adequate and orderly records of their business and internal organisation.”

The MiFID Regulations outlined above set out an obligation for each firm to ensure effective reporting of information and that adequate records are maintained. 45% of firms were identified to have deficient board reporting arrangements with inadequate reporting provided to the board to facilitate informed discussion. These deficiencies were found in certain cases to originate from a lack of ownership of the activity and a lack of oversight by the board. One area of particular concern was the level of compliance reporting to the board with reports observed in most cases to be limited and deficient in terms of compliance testing and monitoring and legislative updates among others. Firms with detailed reporting arrangements were found to have an appropriately informed board with active participation and robust challenge at board meetings. These boards were also found to request additional information and make suggestions to improve the reporting process.

Similarly, 45% of firms were found to have maintained inadequate board meeting minutes. Typically meeting minutes lacked detail of either discussions held or decisions reached or both. They were often overly brief and as such would not enable an independent third party to understand the discussions and contributions that are provided in the board meeting forum. A more comprehensive minute process which summarised the key discussions, individual’s contributions, and action points to be followed, was found to contribute to ownership of activities and demonstrated appropriate board oversight. In certain instances, those firms that did not document comprehensive board minutes were noted to have a decreased understanding of the various elements of the organisation.

Core to the effective functioning of every MiFID firm is the proper and orderly functioning of its board. In order to achieve this it is essential that the board arrangements incorporate basic industry accepted operating arrangements and that the board retains responsibility for ensuring these arrangements remain appropriate. Industry best practice would suggest that board arrangements incorporate:

- clear agendas for each meeting;
- meaningful written reporting to inform the board; and
- board meeting minutes which adequately document the functioning of the board.

7. *Detailed Job Descriptions should be in place for all staff including board members.*

Regulation 34(1)(a) of the MiFID Regulations states:

“An investment firm shall – (a) establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities.”

The MiFID Regulations require firms to allocate responsibilities and specify reporting lines in a documented manner. Authorised Officers observed this requirement to be overlooked as 64% of firms inspected were found to have deficient and/or an absence of documented Job Descriptions. The allocation of functions and responsibilities can be best achieved via Job Descriptions which should be in place for all staff including directors, both executive and non-executive. Job Descriptions should be reviewed regularly to ensure they remain relevant and current.

Staff and board members awareness of their responsibilities is considered key to the efficient and effective operation of firms. Firms that implemented documented Job Descriptions resulted in staff with increased personal ownership of their responsibilities and understanding as to the appropriate reporting lines. In contrast, a number of the firms which had failed to establish and implement Job Descriptions for staff, were noted to have a reduced understanding of their personal responsibilities in their role.

8. *Firms should ensure that their Organisational Charts are current, up to date, reflective of reporting lines and consistent with actual practices within the firm.*

Regulation 34(1)(a) of the MiFID Regulations states:

“An investment firm shall – (a) establish, implement and maintain decision-making procedures and an organisational structure which clearly and in documented manner specifies reporting lines and allocates functions and responsibilities.”

Organisational charts were requested from all firms as part of the pre-inspection submission. While all firms provided documented charts, 45% of these were found to be out of date or failed to capture the actual reporting arrangements in place. In particular it was repeatedly noted that the role and reporting lines of the board and its non-executives was often omitted.

The inspection process identified firms with documented organisational charts which included roles and reporting lines, to have increased ownership of functions and understanding of the appropriate reporting lines within the firm. These firms demonstrated increased escalation from staff to senior management and displayed an environment of open communication. Furthermore, the inspection series observed firms with out of date or a lack of documented organisational arrangements to contrast directly with the benefits above and exhibited a lack of ownership of activities and appropriate reporting.

9. *Firms should carry out an annual review of board performance and corporate governance arrangements.*

In addition to the necessity of appropriate board structures providing for robust challenge and effective decision making the inspection process identified stand out best practice to include an annual review of the board’s performance and the corporate governance arrangements implemented. Firms which have adopted this practice were found to evolve in line with developments in industry and exhibited a strong culture of good corporate governance. Such a review should consider the balance of the board, the firm’s strategy, oversight of risk appetite and risk management, assessment of the performance of the firm and its senior management.