Consultation on the

Joint ESMA and EBA Guidelines

On the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU

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Milan, January 26th, 2017

Dear Sirs/Madams:

We welcome the opportunity to contribute to the public consultation on the draft Joint ESMA and EBA Guidelines on suitability of the management body of financial institutions, developed pursuant to Articles 91(12) of Directive 2013/36/EU (CRD) and 9 of Directive 2014/65/EU.

Before analyzing specific provisions of the proposed Guidelines, two general observations are necessary.

The first one is that the regulatory approach followed, at least generally and to the extent that it is possible to simplify, adopts what in the existing legal literature are sometimes defined as "standards," as opposed to "rules." With the former expression we refer to provisions setting forth individual and collective requirements for board members clarifying the substantive goals of the requirements, but not indicating mandatory, specific and rigid requirements. One of many possible examples is section 7 of the Guidelines concerning knowledge, skills and experience. This section, rather than listing specific criteria for board membership (e.g. certain professional qualifications, a minimum period and type of experience in the industry), and differently from the approach followed in some Member States, offers general principles that require to be interpreted and applied to concrete factual circumstances. Needless to say, the distinction between rules and standards is not a black or white one, but rather a continuum presenting many shades of gray, and few systems opt exclusively for either one approach: a

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combination of rules and standards is virtually always necessary to effectively regulate this matter.

The approach followed by EBA and ESMA relies however unequivocally on standards. This is both necessary and desirable, but raises delicate questions. It is necessary and desirable considering the fact that the new framework will apply to Supervising Authorities and Financial Institutions operating in a legal context only partially harmonized, and in which significant local differences among Member States still exist. In a similar situation, it seems inevitable to adopt a potentially more flexible approach that can be more easily applied in different jurisdictions with different legal traditions, systems and regulatory and business cultures. At least in theory, the approach is also desirable because it allows a substantive and not formal evaluation of suitability.

The possible drawback, however, is the uncertainty that this approach might determine for the financial industry, and the broad discretion it might grant to regulators. Consider, for example, that reputation, honesty and integrity of individual board members (paragraph 9) should be evaluated also in light of "any evidence that the person has not been transparent, open, and cooperative in his or her dealings with competent authorities" (section 73(a)). While it is hardly questionable the fact that being transparent, open and cooperative with supervisory authorities is an important indication of integrity, it is equally obvious that the standard is extremely broad and vague, and its application might vary and be interpreted in profoundly different ways.

These observations underline the great importance of how the Guidelines will be actually and concretely interpreted. The real challenge of the new framework, therefore, lays more in how the principles will be applied and enforced, rather than in the principles themselves, principles that often express reasonable and desirable, if not obvious, aspirations. In this perspective, in order to promote a truly harmonized, effective and fair playing field, the development of a set of persuasive, if not binding, "precedents" that will guide private parties and regulators will be absolutely crucial.

The second preliminary remark we need to make concerns the style of the consultation itself. The specific questions asked by the regulatory agencies might be defined as "leading questions," often asking respondents to take a position on the "clarity" of the principles contained in the Guidelines. While it is obviously necessary to enact "clear" Guidelines, focusing the attention of stakeholders on this issue, and leaving less space to commenting and discussing the merits of the regulatory options, does not seem desirable. A principle can obviously be entirely clear – and, in fact, this is a truly minimum standard of good regulation – but be entirely ill-advised on the merits. We do understand the convenience of forcing respondents to follow a coherent and standardized set of questions in order to effectively collect and compare comments. The particular structure and content of the questions, however, seems to limit excessively the ability of commentators to provide critical considerations. For this reason, we offer our responses in a still brief but less structured letter, hoping it might still contribute to the discussion.

Our observations with respect to specific provisions are as follows.

We start with paragraph 10 (“Independence of mind”) and note immediately that it is not clear whether the requirements of independence set forth in this part should be met by *all* board members, or *only* by the ones that qualify as independent. There is of course a profound difference between being able to act with “independence of mind”; and being formally qualified as independent (or, in some systems, “outside”) directors. The former is an attitude and a personality trait that all directors should have, including, for example, the CEO; the latter is a precise qualification based on more formal and precisely defined requirements concerning the absence of current or past relationships with the managed entity, other directors or top executives, controlling shareholders, other entities belonging to the same group, and a number of other influent stakeholders that might negatively affect the independence of the director and cast a doubt on her inclination to pursue exclusively the interest of the entity. As everybody knows, no legal system in the world requires all directors to be qualified as independent or outsider. On the contrary, the presence of “inside” or “executive” directors is an obvious and unavoidable necessity and, in fact, an element of good governance.

The Guidelines seem to recognize this, for example by regulating, with respect to time commitment, the circumstances in which the same person holds multiple directorships within the same banking group. However, a textual reading of paragraph 10 might suggest that all directors should be independent and that, in order to establish this, the long and extremely broad list of situations spelled out in section 77 should be considered. An excessively broad and rigorous interpretation of the situations indicated in section 77, which range from “personal” “relationships with relevant external stakeholders” to “economic relationships” with “entities included within the scope of prudential consolidation” presents the concrete risk of disqualifying an extremely large number of individuals, including individuals that it is in fact desirable to appoint on the board of financial institutions, due to their skills, expertise, knowledge of the industry or the geographical areas in which the entity operates.

Of course, an easy objection is that the Guidelines are broad and substantive, and need to be interpreted and applied correctly by the different authorities involved in their enforcement. The danger of excessive discretion, and adverse selection of potential candidates, should however be considered more carefully by the regulators.

With respect to paragraph 9 (Reputation, honesty and integrity), some of the criteria indicated do not seem to be relevant in terms of reputation, honesty and integrity but, if at all, in terms of independence of mind. For example, section 72 takes into account issues such as having a negative credit score, having declared personal bankruptcy, having contracted large loans or made significant investments with an impact on the financial stability of the individual or entities owned or directed by her, or being involved in civil lawsuits. These criteria, essentially concerning the financial position of the individual or her litigiousness, might suggest a particular propensity to financial risk or risk more generally, and personal characteristics, but they seem less related to moral character, at least in the absence of specific violations of legal rules or good business practices. Of course a possible counter-objection to our observation is that the very flexibility and vagueness of the Guidelines imply a factual evaluation of the totality of the circumstances, but there is a significant risk that including similar variables in the assessment of the integrity of a person will lead to undesirable uncertainties or unfair results.

Notwithstanding the fact that the Guidelines mention the presumption of innocence, the broad reference to all criminal and administrative proceedings, and civil litigation, seems also quite broad. With specific respect to criminal proceedings, including simple investigations, one should keep in mind that in some legal systems there is no, or very limited, prosecutorial discretion in deciding what facts to investigate and prosecute. In other words, it might be sufficient also a frivolous denunciation by a third party to trigger a mandatory inquiry by the prosecutor, that might jeopardize the suitability of a person.

More generally, and again notwithstanding the possible argument that standards must by definition be broad and require fair and scrupulous enforcement, the criteria set forth in paragraph 9 seem decidedly too broad, and the reference to the "proportionality principle" set forth by Paragraph 4 mitigates, but does not eliminate, the concern of a discretionary and ambiguous application. We also wonder if it might be preferable to consider also the record of an institution in terms of regulatory compliance within the elements that should be taken into consideration to determine the proportionality of certain measures. Should an institution that has not been sanctioned or otherwise been found in violation of relevant provisions be granted more flexibility in the application of the Guidelines? Could a good track record in this respect be considered an element of lower risk, and therefore be relevant in terms of proportionality?

With respect to time commitment (regulated by Paragraph 5), section 44 is potentially too broad and could impose excessive and unnecessary costs to banks and financial firms. Institutions are in fact required to keep records of "all external professional, political and other functions and relevant activities exercised by the members of the management body", with the additional obligation to update them not only when a board member informs the institution of a change, but also when "such changes come otherwise to the attention of the institution". Also this requirement, at least if interpreted in a rigorous and extensive manner, might easily cause the costs of the regulatory framework to exceed its benefits.

With respect to conflicts of interest, we support the idea that cumulating managing and control functions might lead to conflicts. It should be noted, however, that some European jurisdictions regulated corporate governance adopting a more nuanced distinction between management and supervisory functions. In some instances, it might consequently be difficult to correctly interpret and apply this principle to specific national systems.

From a procedural and more practical perspective, it is questionable if and how private institutions, and to some extent also regulatory authorities, can legitimately, effectively and efficiently acquire such a broad set of detailed, often personal information. To rely on self-declarations of candidates or nominees is problematic, if nothing else, for the sheer quantity and detail of information that would need to be disclosed. Equally problematic is the possibility of third parties to conduct inquiries on either public or (and even more) non-public records concerning all the numerous aspects mentioned in the Guidelines. The problem is even more serious considering that no relevant period is indicated by the

Guidelines, with the consequence that potentially also events of a distant past might be considered relevant.

Also from a procedural perspective, a more precise and narrow definition of when institutions should reassess the suitability of their boards would be desirable. For example, section 26 of paragraph 2 requires, among other things, a new evaluation of the collective suitability of the managing board whenever "there is a material change to the institution's business model, risk appetite or strategy or structure at individual and group level." This definition is clearly extremely broad, determining uncertainties concerning the triggering events that might require a re-evaluation (a time consuming and expensive procedure, should be mentioned). In addition, we believe that the assessment of suitability should, to the extent possible, cover the entire length of the board's mandate and that it should consider, in principle, also the need of periodically adjusting the risk strategy and the business model and, more generally, to face change. In this respect, the Guidelines should be further specified (or, at least, strictly interpreted) as requiring a reassessment only when truly major substantial changes are discussed and approved by the board (e.g. in case of mergers, major acquisitions, offerings or IPOs in other markets and so on). Otherwise, board's members could refrain from adopting changes in order to avoid the reassessment procedure and its possible effects on their personal position. Moreover, the broad standard envisioned by the Guidelines also appears potentially contradictory in certain situations: a board not suitable to manage a corporation that has adopted a new and different business model, or strategy or risk appetite, in principle should not have been able to evaluate competently!

We appreciate, on the other hand, the relevance given to training and induction of new board members, something that in some systems is still largely left to the preferences and good will of single organizations.

One final comment concerns the procedural application of the Guidelines on suitability, and specifically the parallel consultation on the EBA Guidelines on internal governance. In light of the broadness, flexibility and vagueness of the proposed requirements, outside of the case of authorization to the establishment of a new organization, to impose an ex ante approval by competent authorities of the new members of the management body of a financial institution might be unadvisable. While an informal dialogue with the authorities might be desirable and effective, to require a preliminary administrative approval might cause the appointment process to become unnecessarily cumbersome, slow and costly. It seems preferable to attribute to individual candidates and nominees, and to financial institutions, the responsibility to comply with the substantive criteria adopted, while supervising authorities can intervene ex post in case the requirements do not appear respected.

To conclude, we once again underline the broad discretion, with very limited checks, that the Guidelines grant to competent authorities. This might lead to inconsistent, ineffective and even unfair results, and creates a potential risk of having boards of directors, substantively, appointed by public supervisors or, at least, only with their approval. This situation determines risk in terms of responsibility and reputation for supervisors. In other words, our overall evaluation is that we share the spirit of the new Guidelines and believe that they offer many useful criteria to evaluate the collective and individual suitability of board members. We are also concerned, however, that their broadness, if not vagueness, might lead to very inconsistent results depending on how they are interpreted and applied, with the consequence that they might result either not prescriptive enough, and therefore not very useful, or so broad and rigorous to exclude many potential qualified and desirable candidates from board positions.