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1 CORPORATE GOVERNANCE AND BUSINESS ACTIVITY – REGULATORY OUTLINE

Objectives, background and legal basis

The regulatory framework for good corporate governance and business activities is designed to ensure that the management of supervised entities is duly qualified and that supervised entities have in place business principles and practices of high ethical and professional standards.

Exercise of sound corporate governance promotes the stable development of the financial system, improves its economic efficiency and enhances investors' confidence in the market. It also emphasises and supports the supervised entities' own responsibility in the conduct of its business. Sound corporate governance practices in supervised entities and financial markets will also provide support to the FIN-FSA in its supervisory functions.

Corporate governance

The term *corporate governance* can be defined as involving a set of relationships between a company's senior management, its board (board of directors/supervisory board), its shareholders and other stakeholders in the conduct of the company's business.

Primarily, the corporate government framework builds on a set of corporate government standards and guidelines issued by the OECD and the Basel Committee on Banking Supervision, more specifically the *OECD Principles of Corporate Governance 2004*, the Basel Committee's paper of September 1999, entitled *Enhancing Corporate Governance for Banking Organisations*, and the *Recommendation for Corporate Governance of Listed Companies* issued jointly by the Helsinki Stock Exchange (HEX), the Central Chamber of Commerce of Finland and the Confederation of Finnish Industry and Employers, which came into force on 1 July 2004.

Key elements of sound corporate governance under the OECD Principles:

- to protect the rights of shareholders and facilitate the use of these rights
- to ensure equitable treatment of shareholders
- to consider the interests and rights of various stakeholders
- to disclose timely and appropriate information on essential matters related to the company (financial situation, operations, shareholders and governance)
- to ensure that the board takes responsibility for managing the company and making their decisions in a professional and accountable manner (the board bears responsibility for oversight of senior management).

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The Basel Committee on Banking Supervision sees corporate governance as furthering the aims of public supervision by helping ensure the sound operation and stability of credit institutions. Public supervisors therefore have a clear responsibility to see that credit institutions have in place corporate governance practices that are based on sound, clear and consistent business and monitoring principles. The Basel Committee underscores the need for banks to set strategies for their operations and establish accountability for the execution of these strategies. The provision of adequate and accurate information on the organisation and on decisions and actions is integrally related to accountability.

The Basel Committee on Banking Supervision supports the OECD guidelines and sets the following criteria for sound corporate governance practices in companies operating in financial markets

- establishment of clear strategic objectives that are embraced by the entire organisation
- clearly defined responsibilities throughout the organisation
- qualified board members, who are not subject to the influence of senior management
- appropriate oversight by senior management
- recognition of the role and importance of internal and external auditors
- bonus schemes that are consistent with the company's strategic objectives and do not give rise to conflicts of interest detrimental to the interest of customers and investors.

Finnish national legislation does not provide a concentrated framework for these issues. Instead, the relevant provisions are scattered between diverse acts on corporate structures or institutions. On the other hand, specific sections of law governing stakeholders and their rights and responsibilities (incl. customer protection and labour law) do exist.

The OECD Recommendations are primarily designed for listed companies, but it is recommended that they be applied also by other companies. Nonetheless, all service providers in the financial markets fall within scope of the Recommendations. The requirement for sound corporate governance is written into the key provisions governing authorisation entailed in the Credit Institutions Act, the Investment Firms Act and the Mutual Funds Act. In keeping with these provisions, credit institutions, investment firms and management companies shall be managed in a reliable and professional manner and in line with sound and prudent business principles.

Business activity

Business operations must be so planned, managed, organised and controlled as to enable the supervised entity to guarantee operations of high professional and ethical standards. Also the systems – including customer identification and KYC (know your

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customer) procedures – must ensure that criminal abuse of the supervised entity can be avoided.

Provision of services in financial as well as securities markets is, as a rule, subject to authorisation. This constitutes an exception to general freedom of trade, which is justified considering the social importance of these operations and the ensuing particularly high reliability requirements. The requirement for authorisation also enhances customer and investor protection.

Regulations on the business activities of financial market participants are set out especially in the Directive relating to the taking up and pursuit of the business of credit institutions (hereinafter the Credit Institutions Directive), in the Directive on investment services in the securities field (hereinafter the Investment Services Directive) in the Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (hereinafter the UCITS Directive). The Directives also apply to the conduct of cross-border business and provision of services through a branch office situated within the territory of another EEA country, without the establishment of a branch across the border. The single licence principle and the principle of reciprocity apply within the European Community. Corporations authorised under the single licence principle may also provide services in another EU member country. The principle of reciprocity, in turn, means that member states must mutually recognise the minimum harmonisation measures set out in the Credit Institutions, Investment Services and UCITS Directives.

The provisions on business practices entailed in the Directive have been transposed into the Credit Institutions Act, the Mutual Funds Act and the Investment Firms Act.

Supervisory approach

Management responsible for maintaining sound corporate governance practices

The FIN-FSA takes the approach that the executive bodies bear special responsibility for ensuring that the supervised entity has sound corporate governance practices and a clear organisational structure in place, that there is an official division of duties and responsibilities between the board (board of directors/supervisory board) and senior management and comprehensive internal audit processes. The management of the company must therefore meet strict fit and proper criteria. Considering that the responsibility for the conduct of the supervised entity's business rests with the board, which is not under the influence of senior management, the FIN-FSA will bring to the board's attention all major problems discovered in the exercise of its supervisory duties and will require that they be remedied.

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The FIN-FSA highlights the role of auditors

The FIN-FSA recognizes the important role played by the auditors in their capacity as owner-elected supervisors of the company and as an instrument of corporate management. In order for the company to fully benefit from this, its owners and board must recognise and acknowledge the importance of the audit process, make effective and timely use of auditors' observations and design an effective auditor reporting system that also highlights the independence of the auditors. They must also call on senior management to remedy any defects identified by the auditors.

The auditors of supervised entities are under a statutory obligation to notify the FIN-FSA of essential matters pertaining to the company's business or of company decisions, and thereby this obligation provides support to the FIN-FSA in its supervisory functions.

Key role of internal control

The FIN-FSA emphasises the key importance of supervised entities' own internal control processes. Supervised entities are required to have an organisational structure with a built-in system of adequate checks and balances to support operations and the decision-taking process. Companies must have effective internal control and information systems to ensure that the board and senior management can, in the best way possible, meet with their corporate governance responsibilities. Internal control also involves risk management duties and obligations to document decisions and agreed divisions of responsibilities.

Corporate structures must not impede supervision

Corporate or ownership structures must not impede supervision by the FIN-FSA. The FIN-FSA therefore focuses special attention on the clarity of business and ownership structures of large financial conglomerates. Organisational structures and the corporate governance framework must be clearly documented.

FIN-FSA regulations on business activity designed to clarify scope of permissible activity

The FIN-FSA endeavours to clarify the scope of activities permissible to financial market participants under financial market legislation. The FIN-FSA finds it important to ensure the sound development of the business of financial market participants. Within the limits defined by the legislator, the FIN-FSA aims at interpreting existing legal provisions on the business of supervised entities as covering new products and practices, without legislative amendments being necessitated in immediate response to changes in the operating environment.

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Main contents

Market entry

The requirement for authorisation constitutes one of the key areas of corporate governance regulation. It is designed to ensure that financial operations are only carried out by corporations with a duly qualified and reliable management, adequate internal control and risk management systems and capital adequacy levels, a sound internal governance framework and appropriate information systems. Entry control is also necessary for ensuring that the company has in place corporate structures and business practices that are clear and consistent both to the market and to the supervisor. It should be noted that supervised entities must continue to meet the criteria for authorisation as long as they remain in business.

The standards in this section address, for example, the establishment of credit institutions, investment firms, pawn shops, management firms and custodians and the regulatory principles of authorisation.

In its guidance, the FIN-FSA sets out what information on future business activity, capital adequacy, profitability, internal governance, internal control and risk management it will need for assessing whether the applicant meets the criteria for authorisation. The regulations on the fit and proper assessment of the owners are provided in the FIN-FSA standard on owner control, whereas the corresponding regulations pertaining to the management are provided in the FIN-FSA standard on the fit and proper assessment of managers and persons in charge of key business areas.

The corporate governance framework has been divided into three standards as follows:

- 1 Owner control
- 2 Internal governance
- 3 Fit and proper assessment of managers and persons in charge of key business areas

FIN-FSA regulations on the obligation to provide information are outlined in the information disclosure section.

Owner control

The regulations on owner control address the control powers, measures and approaches available to owners. The role of the auditor in the context of owner control is also outlined in this standard.

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Internal governance

The regulations on internal governance address the duties of the board (board of directors/supervisory board) and senior management and the role and basic approaches of the internal audit and compliance function. The regulations are designed to clarify the responsibilities of the various players and the division of duties and between them.

Fit and proper assessment of managers and persons in charge of key business areas

The fit and proper standard defines fitness and propriety criteria for managers and persons in charge of key business areas and obliges the board to set up a system of monitoring compliance with these criteria.

Supervision of financial and insurance conglomerates

The standard on the supervision of financial and insurance conglomerates addresses the purpose and core principles of conglomerate supervision and discusses the regulations on conglomerates set out in other sections.

Consolidated supervision

The standard on consolidated supervision addresses the purpose and core principles of consolidated supervision.

Business activity

In the regulations on business activity, the FIN-FSA draws a distinction between permissible and non-permissible activities.

Outsourcing

In the regulations on outsourcing, the FIN-FSA sets out its opinion on various operational arrangements, such as outsourcing and use of representatives.

Interrelationship with other sections

Standard 4.1 on the establishment and maintenance of internal control and risk management, included in the section on capital adequacy and risk management, contains more detailed regulations on the internal control function.

FIN-FSA regulations on the obligation to provide information are outlined in Section 5 on information disclosure, while the section on reporting includes guidance on the reporting requirements and practices associated with this section.

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Standards falling under to this section

The standards falling under *corporate governance and business activity* are listed by subject matter below:

- Market entry (under preparation)
- Owner control (under preparation)
- Internal governance (under preparation)
- Fit and proper criteria for managers and persons in charge of key business areas (under preparation)
- Consolidated supervision (under preparation)
- Supervision of financial and insurance conglomerates (in force)
- Business activity (under preparation)
- Outsourcing (under preparation)