Expert view: Decision-making processes and responsibilities

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In the first of a series of regulatory columns by experts in Guernsey's legal sector we consider the decision-making processes and responsibilities that affect private banks, asset/fund management companies including discretionary fund managers, family offices, depositories, wealth/financial advisors, paraplanners and relationship managers.

It is with much pleasure, anticipation and some trepidation that I write these first lines in a series of articles commissioned for *Compliance Matters* on the topic of regulation. To those who have worked in and around the Guernsey finance industry over the last few years, trepidation will be a familiar feeling. We, perhaps more than most, have been caught up in the storm of regulation and regulatory enforcement that has followed on from the global financial crisis and which has picked up pace with each big splash about leaked documents and such.

Never have the demands been so onerous, and the personal risk so great, as it is right now. Pleasure and anticipation are perhaps less commonly associated with regulation. However, to succumb to fear of regulation is to miss the opportunity that these conditions create. Regulation is a fact of life. If as a business, as a jurisdiction, we embrace the regulatory burden and discharge it better and more efficiently than our competitors, we create the kind of competitive advantage that will no doubt enhance the reputation of the island as a financial centre and benefit our collective top and bottom lines as a result.

This month, we look at three current themes in relation to 'decision making', drawing upon what we have seen coming across our desk from the 'pointy end' of the regulatory stick, that we think provide some useful guidance for industry.

Decisions, decisions…

Thus, a great step forward has been taken. Responsibility is personal and it will no longer be possible to inflict penalties on persons who have themselves not committed the acts complained of…[Collective Punishments]strike at guilty and innocent alike. They are opposed to all principles based on humanity and justice..

- ICRC Commentary on Art 33, Fourth Geneva Convention, 1949 (Prohibition on Collective Punishments)

Directors should take collective responsibility for directing and supervising the affairs of the business.

- Guernsey Financial Services Commission Code of Corporate Governance for Finance Businesses

The juxtaposition of the above two statements is a little cheeky. The eagle-eyed, and those with an interest in international criminal law, will immediately point out that those statements of principle are dealing with two distinct concepts. But, that is the point. Whilst undoubtedly all members of such decision-making responsibility, individuals can (or should) only be held to account, or punished, for what they personally did or did not do. The difficulty, for the regulated and the regulating alike, is to recognise this distinction in practice; when both taking and reviewing decisions taken by boards, trustees and other collective decision-making bodies.

We have seen a number of recent regulatory cases where the way in which decisions are made (or not) has been closely scrutinised, with a focus on the notions of exactly who is responsible for what, and to what degree.

1. 'Apportioned' decision making

This issue most obviously arises in the investment sector, although a slight change of the facts will apply it to most trust business as well. The typical investment structure has an investment company (or cell) board. The board typically appoints a manager to manage the company's business, who in turn appoints an administrator to administer the company, and an investment advisor to invest the assets of the company. Responsibility for the success of the venture is peeled away like layers of an onion.

Now there is nothing wrong with this in principle – in fact, there is a lot right with it. I would rather have an investment expert looking after my investment than someone less qualified. However, the risk is that a firm that apportions responsibility can be confused as to who is responsible for any given tasks or, worse still, ignorant of particular responsibilities. It is all too easy for the board to consider that, having effectively outsourced the entire operation of the company to others, there is nothing left for them to do. On the other side of the equation, it would be nonsensical to ignore the legal and commercial realities of the structure and try to tie down responsibility for all failings, to all involved, at all levels.

In striving for a more sophisticated approach to the question of responsibility, we need to analyse the relevant jobs and responsibilities more closely. In the example above, where the substantive functions of the company have been apportioned out to others, it is these persons who should be held responsible for the performance of those functions. However, the board that ultimately appoints them must at the very least retain responsibility for the selection, monitoring and review of its appointees. Responsibility for running the company cannot be delegated entirely. A proper appreciation of these different jobs by both the regulated and regulators alike will allow directors to discharge their functions, secure in the knowledge that any review of the board's conduct should reflect this more restricted nature of their role in such circumstances.

2. Corporate directors

As is typical in offshore structuring, the boards of client companies are comprised of corporate directors supplied by the Guernsey finance business – e.g. XYZ Nominees No 1 and No 2. That is perfectly fine from a company law perspective, and great from a risk, continuity and administrative perspective. The individuals actually operating the corporate directors can change as people come and go, or are in or out of the office on any given day, but the formal board structure remains unchanged. However, people can forget that even in this type of structure, at some level, somewhere, two or more real live people are sitting in a room making a decision.

The act of adopting the corporate director structure does not absolve these individuals from the usual types of obligation that directors

must discharge when they take decisions on behalf of the company in question. It is the individuals who sit on that 'higher' level board who will be open to criticism and regulatory sanction for any failures at the next level down. Therefore, they ought to comply with those obligations by making rational decisions in a rational way. The production of bland standard-form minutes recording the fact that Nominee 1 Ltd and Nominee 2 Ltd made a momentous decision is no good at all.

The challenge, and the opportunity, lies in ensuring that corporate directors and their board members discharge their obligations within a system that retains all of the advantages of the corporate director structure in the first place. The obvious response is to prepare detailed minutes of discussions at both levels. This is unlikely to be practical in many situations and will cost the client money. There may be alternatives, though. One possible solution we have discussed with clients is to establish robust protocols that set out ways in which individuals make decisions on behalf of corporate directors. Such a process could set out levels and/or spheres of responsibility for the various individuals who discharge the functions of a director for client companies, which could be voted on once and then (subject to periodic review) left to run. These things are very fact-specific and there are no doubt other ways. The important message for businesses that run corporate directors, or those people who operate them, is that the responsibility exists and ought to be considered and addressed.

3. Different skills, knowledge and functions

The 'sleeping' director used to be commonplace. In fact, as I and my colleagues recently discovered whilepreparing for a talk on directors' duties, in the 19th century the idea of an appointment providing an ignorant director with nothing more than ‘a little pleasant employment without …incurring liability’ was a principle actively supported by the courts. Attitudes have, of course, changed and there have been numerous cases in the civil courts where the expectations of directors, and in this context particularly non-executive directors, have been spelt out clearly.

To avoid civil liability, all directors must meet a minimum ‘reasonable’ standard of rigour in the way in which they go about their jobs, but what about those directors with special skills, or a director whose designated role is ‘legal director,’ or those who know more or less about any area of this business? In the civil courts, the most recent case law suggests that the standard to be applied does include subjective consideration – taking into account this-or-that director's special skills, for example. The catch is that the standard only goes up – which is a pity for particularly unskilled directors, who are still obliged to achieve a reasonable level of competence in the discharge of their duties.

Most of this case law has been in the civil courts; it will be interesting to see how these issues are dealt with in a purely regulatory context. Directors of regulated entities do have specific duties they ought to discharge which are often set out in primary or secondary legislation. Often, however, directors of regulated entities bring their own very specific skills to the board – some might be experts on the underlying activity of the company, others may be experts in the regulatory mechanism itself, whilst others could be professional directors. In reviewing their conduct, will the regulator apply a basic minimum standard? Which skills will attract a higher standard, if any? To what extent can the directors rely on each other to discharge their functions in their respective areas of expertise?

To be a director is to do an important job. You have the financial fortunes of the members, employees and creditors, and in this jurisdiction, the jurisdiction itself, in your hands. It is, perhaps, only right to approach any appointment or any decision with an appropriate amount of caution, but not with fear. As long as directors have a close and careful understanding of the nature of their

responsibilities and as long as they do all they personally (and reasonably) can to fulfill those responsibilities, they should have nothing to fear.

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