

TASKFORCE ON IMPROVING INTERNAL CONTROL OF FINANCIAL COMPANIES ANNOUNCES INTERIM RESULTS

The taskforce on improving rules regarding financial companies' internal control announced its interim discussion results on November 29. The key discussion details focus on strengthening the role and responsibility of chief executives, boards of directors and executive officers over their companies' internal control affairs to boost the effectiveness of internal control mechanisms.

BACKGROUND

Pursuant to the requirement for internal control standards and procedures (Article 24-1) prescribed under the Act on Corporate Governance of Financial Companies, all financial companies are currently operating their own internal control mechanism to prevent illegal activities committed by their executive officers or employees and the like. It is aimed at avoiding the risk of potential loss in the future and erosion of a company's reputation related to the soundness of company management and consumer protection. Since its introduction, there is an increased level of awareness throughout financial sectors about the significance of internal control.

However, in reality, as setup and operation of an internal control system requires considerable efforts and costs, different companies have different levels of internal control standards and procedures, which vary significantly depending on the business strategy and willingness of the management. The more a company focuses on short-term performances, the more its internal control will remain perfunctory, which will probably prove inadequate in its function and effectiveness for the operation in the field.

In particular, the successive occurrence of a number of financial accidents such as incomplete sales of financial products and large-scale embezzlement recently has raised the awareness and concerns about internal control of financial companies. Apart from inflicting losses to consumers and shareholders, financial accidents can have a significant impact on the overall health of the economy and society with a degradation of trust in financial sectors. Therefore, besides penalizing those who have committed illegal activities, it is also necessary to ask the question of whether the company and the management as well as the board of directors, which has a duty to supervise the management, had their roles properly performed.

The FSC and the Financial Supervisory Service have been operating a taskforce on improving internal control of financial companies and have been exploring ways to induce financial companies to build and comply with effective internal control mechanisms on their own for prevention of financial accidents.

CURRENT REGULATORY SHORTCOMINGS & DISCUSSION FOR ALTERNATIVES

Questions and comments have been expressed on the effectiveness of present regulations on internal control in averting financial accidents.

First, as it has been evident in the mis-selling of private equity funds such as derivatives-linked funds (DLFs), it is addressed that the current criteria for determining the scope of executive officers and employees' responsibilities that need advance establishment of related procedures to be observed during performing them and ascertaining compliance with internal control standards are unclear.

Moreover, there are opinions that financial companies tended to focus mainly on perfunctorily preparing the form and procedures of internal control merely to comply with their legal obligation, and that it was insufficient to promote financial companies to move toward the management policy and organizational culture that treat internal control as a material matter.

Also, there are opinions about the problem of ambiguity in who should play which role and who should bear the responsibility when a financial accident occurs because the location of roles and responsibilities among members within an internal control-related organization is unclear. Furthermore, when the authority over internal control is delegated to subordinates, executive officers can escape from their responsibility, which sometimes leads to an unintended consequence of instigating ignorance and indifference to their companies' internal control affairs among executive officers.

Therefore, the taskforce on improving rules regarding internal control of financial companies held discussions on a variety of alternative measures suggested by different financial sectors as summarized below.

- a) Make current rules on the obligation to set up internal control standards clear and specific

With regard to the internal control standards financial companies are required to set up, it was suggested that the regulation needs to be made more clear and specific for which specific duty and what kind of standards and procedures shall be prepared. There also was an opinion that an overhaul in multiple layers of internal control standards prescribed under a number of different laws—the Act on Corporate Governance of Financial Companies, the Act on the Protection of Financial Consumers and the Financial Investment Services and Capital Markets Act—should also take place at the same time. However, since this is expected to take a long time, there have been calls to make continuous efforts to bring about improvements by taking into account best practice examples collected from both at home and abroad.

- b) Impose a duty to supervise internal control system on CEOs and executive officers

It has been suggested that a clear duty to manage internal control affairs should be imposed on financial companies' CEOs and executive officers, requiring them to not only set up internal control standards but also to evaluate the appropriateness of their

established internal control mechanisms, carry out inspection on the operational status and employees' compliance, and make adjustment and improvement accordingly. For this, it has been suggested that an executive officer should be designated in advance as a "chief internal control management officer" who is mandated with preventing financial accidents within his or her area (his or her scope of duties) to provide a clear line of responsibility. At the same time, there have been calls to launch an incentive system in place, which will keep the duty of CEOs and executive officers from resulting in the strict liability, that will help reduce the severity of penalties or grant an exemption from sanctions for executive officers whose internal control mechanisms were proven to have worked properly even during a financial accident was taking place.

c) Strengthen the board of directors' duty to supervise internal control affairs

It has been suggested that the supervisory duty of the board of directors should be clearly indicated for internal control affairs to ensure that the principle of checks and balance in corporate governance structure contributes to enhance the effectiveness of internal control.¹ For this, there have been calls to grant additional duties and power regarding internal control to boards of directors apart from their current capacity to deliberate and resolve enactment and revision of internal control standards under the Act on Corporate Governance of Financial Companies (Article 15-1).

APPROPRIATE DIRECTION OF REGULATORY IMPROVEMENT

After several times of discussions, the taskforce reached a consensus that the most urgent task is to strengthen the last responsibility regarding internal control of financial companies of company CEOs, boards of directors and relevant executive officers who have the authority to control, which exerts significant impact on the organizational culture and performance of companies. In this regard, the taskforce established the principle, first of all, that "authority" regarding internal control can be delegated but the act of delegating does not allow one to avoid related "responsibility." Second, the taskforce resolved that, when a financial accident takes place, company executives shall actively explain "what kind of preventive efforts have been made"—not excuse that "they had not been aware of the accident"—and if they fail to adequately explain, they should be subject to sanctions. The taskforce will articulate this concept of common sense into rules. More specifically, the taskforce discussed the following three measures of regulatory improvements.

a) **(For CEOs)** Impose a duty to manage company's internal control affairs to prevent financial accidents → Comprehensive responsibility

CEOs of financial companies will be obligated with the most comprehensive management duty over internal control affairs and be required to take appropriate measures to prevent the occurrence of financial accidents. However, as it is difficult in reality for CEOs to prevent all financial accidents, the scope of their responsibilities

¹ Commercial Act (Article 393-2) The board of directors shall supervise the performance of duties by directors. Commercial Act (Article 393-3) Directors may request that the representative director report on the affairs of other directors or employees to the board of directors.

will be limited to severe “material financial accidents” which can have a serious impact on the society, consumers and the soundness of financial institutions. Furthermore, the occurrence of a material financial accident will not automatically lead to penalties on a CEO. If the CEO had set up internal rules and a system expectable to detect and prevent that particular type of financial accident like the occurred one, and if the CEO had administered to ensure that the internal system properly operated, it will be presumed that the CEO had faithfully carried out his or her duty to manage internal control affairs and the level of his or her culpability will be reduced or set to zero.

- b) **(FOR BOARDS OF DIRECTORS)** Supervise CEO and executive members’ performance of duties → Enhancing the effectiveness of management duties

Authorities plan to establish a legal basis to require company boards to supervise the internal control management duty of company CEOs and executive members. More specifically, boards of directors will supervise the internal control management duty of their CEOs, etc. and have the authority to receive a report on the status of performance of duties regarding internal control from company CEOs.

- c) **(FOR EXECUTIVE OFFICERS)** Strengthen internal control over one’s work area → Establish a structure of work area-based responsibilities

With an understanding that internal control should be exerted as if in an “organic system,” authorities plan to clarify the responsibility of each executive officer across different departments to ensure that all executive officers faithfully carry out their role and responsibility regarding internal control over their areas of business affairs. Executive officers will be obligated with the duty to prevent financial accidents other than the severe “material financial accidents” that fall under the responsibility of CEOs. Each executive officer will be required to directly manage and supervise internal control over his or her own department or line of work responsibility without delegating or passing on his or her responsibility to non-executive subordinates.²

ANTICIPATED EFFECT AND FURTHER PLAN

These measures for rules improvement are aimed at promoting financial companies to treat internal control not as a regulatory requirement imposed on them from outside but as a management strategy and a crucial component of organizational culture. Under the improved regulatory framework, CEOs of financial companies will be encouraged to more properly balance their performance management for generating profits and risk control for preventing financial accidents. Therefore, ultimately, authorities expect that the chances of financial accidents happening will be lowered. Through this, authorities hope that more executive officers equipped with not only competence and a proven performance record but also honesty, integrity and reputation can become more successful.

² Management Responsibilities Map in UK: (a) Each financial institution prepares a “management responsibilities map” describing the scope of responsibility and duty of all executive officers; and (b) When a financial accident occurs that is within the scope of predetermined responsibility of an executive officer, the financial authority can sanction based on the adequacy of internal control efforts made by that particular executive officer.

In addition, by clarifying the line and scope of responsibility regarding internal control, authorities expect that the principle of checks and balance under the corporate governance structure of financial companies will function more actively. As the authority and responsibility of each executive officer for internal control becomes clearer, the boards of directors' supervision and oversight over the management will also be strengthened.

After carrying out a juridical review and collecting opinions from the industry, the taskforce plans to make final decision on the specific details of regulatory improvements and prepare a revision bill accordingly.

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