

FIT AND PROPER ASSESSMENT OF BOARD MEMBERS

Lucia Ana Tomić *

David Tomašek **

Marko Žunić ***

ABSTRACT

Analyzing corporate failures, regulators tagged lack of professional competencies and integrity of board members, supervisory board members, as one of the reasons that lead to bankruptcies. In this paper, the authors will analyze the comparative legal framework for the financial industry in the EU, hard law and soft law regarding this matter, and why it became necessary to full fill other standards in appointing Board members. The financial industry, as the most regulated, proscribed the concept of „fit and proper” criteria for managers, as a standard in corporate governance. The financial industry has its own specifics needed for Board members, so the same criteria might not fulfill the requirements of other industries and there is the need for harmonizing soft law practices. This paper will give an overview and analyze set up criteria and evaluate their ground, purpose, and impact on the assessment. Criteria were set up to examine and evaluate management’s ability to fulfill their duties “fitness”, as well as their integrity and suitability “propriety”. The paper argues why most financial supervision mechanism includes these fit and proper requirements in their regulatory frameworks. Although the matter of Board member’s appointment is not specific to the financial industry, but a common matter for all companies, there is a gap between regulation of the financial sector and other sectors the can be bridged by soft law. The purpose of this paper, from conducted analysis, will be to demonstrate why it is upright for business and to recommend legislator and companies to define the fit and proper procedure for other industries through business practice.

* Lucia Ana Tomić, Wiener insurance VIG PLC, Zagreb, Croatia; lucia.tomic4@gmail.com.

** David Tomašek, Maravić-inžinjering i konstrukcije Ltd., Nedelišće; Croatia; dtomasek@mik.com.hr.

*** Marko Žunić, Žunić Law Office, Rijeka, Croatia; zunic@zunic-law.com.

Following the introductory part, the paper gives a brief historical survey of the United States market, as the one which generally leads the way in setting up the optimum legal tools and market mechanisms. The third part of the paper presents both the general and financial industry's legal framework from the Croatian perspective, with a banking industry as a targeted subcategory. The fourth part of the paper conducts a detailed analysis of the criteria for fit and proper assessment. In the final part, the paper gives de lege ferenda solutions for the Croatian legislator.

KEYWORDS: *Fit and proper, professional competences, integrity, compliance program*

1. INTRODUCTION

Financial industry regulators implemented the concept of „fit and proper” criteria for executive and non-executive directors, not only as a “principle” in corporate governance but as a mandatory element prescribed by law and associated bylaws. It is not surprising that regulations are most rigid for banks, which in case of failure can have huge consequences for the deposit guarantee schemes and public finances.

Rules and criteria are prescribed to prevent the appointment of individuals who might pose a risk for companies. General risks board members meet when trying to run a business are market risk, credit risk, financial and liquidity risk, operational risk, and event risk; with technology and concentration risk as two additional subcategories.¹ Unfit Management Board might pose an operational risk for the company. A manager is a person who is expected not only to have a clear understanding of the aforementioned threats but also to anticipate them in order to mitigate and solve the upcoming challenges. In other words, one must fit and proper to forecast the upcoming threats, analyze internal organizational strengths and weaknesses and act accordingly.² Conducted analyses clearly show that the Sarbanes – Oxley Act³ introduced a smart control path by which the element of board members appointing becomes of the (key) operational risk elements⁴. The strategy ‘If it’s legal, it’s OK’, won’t work⁵. Appointing of the Board members demands much more soft law, guidance, codes, and practice.

The purpose is to ensure that companies have knowledgeable and solid management. Throughout fit and proper process, it must be positively confirmed

¹ Scott Green, Ira M. Millstein: *Manager’s guide to the Sarbanes-Oxley Act, Improving internal controls to prevent fraud*, New Jersey, 2004, pages 35 – 36.

² *Ibid*, pages 47 – 48.

³ [<https://www.govinfo.gov/link/plaw/107/public/204?link-type=pdf&.pdf>] accessed 17/11/2020

⁴ Scott Green, Ira M. Millstein: *Manager’s guide to the Sarbanes-Oxley Act improving internal controls to prevent fraud*, New Jersey, 2004, p. 48.

⁵ Norman Bowie, *Business Ethics in the 21st Century*, Springer, 2013, p 44.

that managers are capable of making prudent decisions and we analyze criteria upon which the company may evaluate and appoint managers with integrity and suitable to set the tone from the top and makes a cornerstone of a prosperous and modern company.

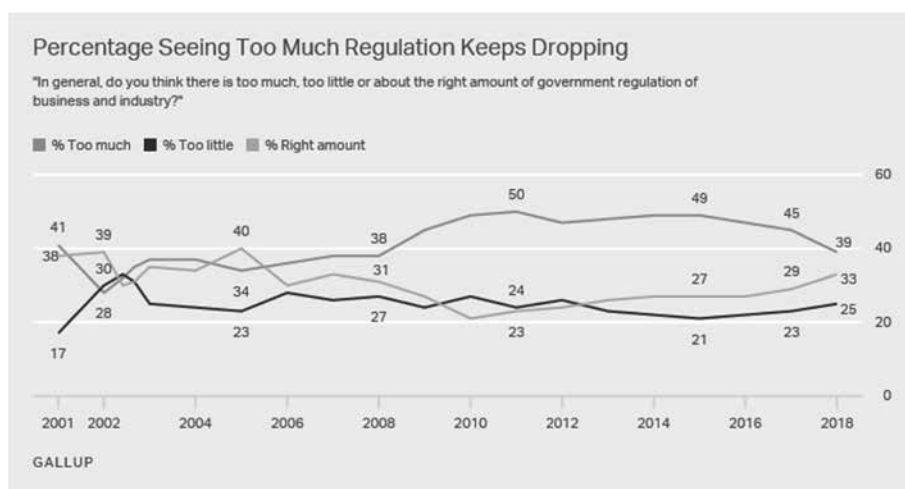
This paper tries to argue the necessity of using the existing practices from the financial industry and making the fit and proper assessment a standard principle in the market as a whole.

2. HISTORICAL OVERVIEW

WorldCom Inc., Enron, Bernard L. Madoff Investment Securities, Wirecard AG... are only a few names in a long list of companies that failed. Some of these can be associated with management malpractice, some with dishonesty, some with greed, but what they all have in common is managers' conduct that is unsuitable for a corporation, let alone a listed one.

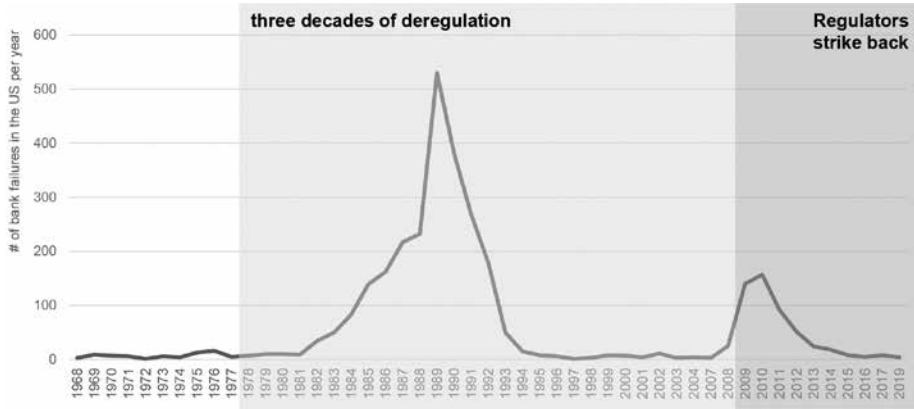
Therefore, it is not surprising that the investment community and the general public had enough of such corporate collapses and scandals over the course of the last few decades. This is reflected in the dropping percentage of people believing there is too much regulation of business and industry.

Chart 1: Gallup research on perception of degree of government regulation of business and industry in the United States⁶



⁶ [<https://news.gallup.com/poll/243662/americans-worry-less-government-regulation.aspx>] accessed on 15/11/2020.

Chart 2: Bank failures in the United States⁷

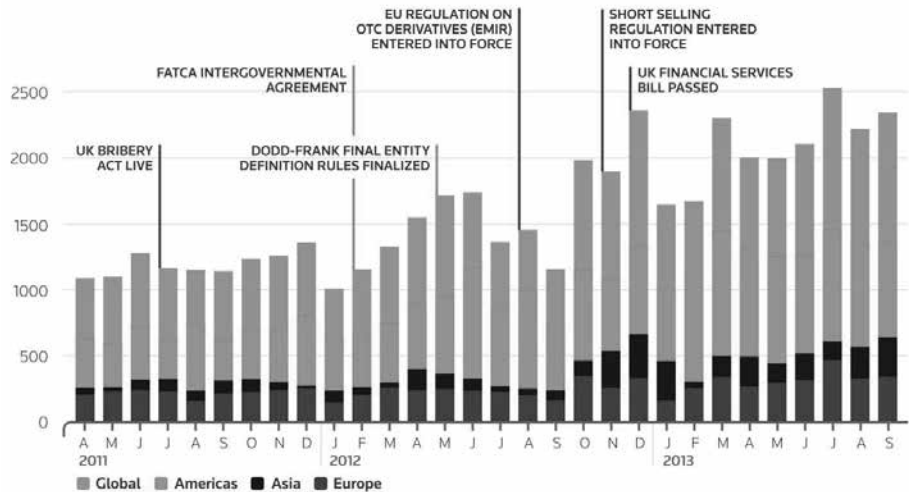


As the world was recovering from the 2007 – 2008 global financial crisis (“GFC”), supervisory bodies and regulators have been relentlessly working, and have analyzed the events that led to the crisis and large corporate and bank failures.

To reduce significant risks arising from moral hazard and management malpractice, regulations were expanded throughout the subsequent years all around the world, with the most severe implications for financial institutions.

Chart 3: Timeline of regulatory activities in the aftermath of the GFC⁸

Regulatory Activity Tracked 2011-2013



⁷ Number of banks in the United States that entered resolution process resulting in bank failure. Source for data: [https://banks.data.fdic.gov/explore/failures/] accessed on 15/11/2020.

⁸ [https://qz.com/138036/how-the-rise-of-modern-regulation/] accessed on 15/11/2020.

One of the curious aspects of this regulatory tightening (as opposed to monetary easing that has been underway simultaneously) was the imposition of higher standards for management board eligibility in financial institutions. Broadly, such an approach is nothing new – the Founding Fathers of the United States recognized that only mature individuals may hold office, e.g. age of candidacy for a US Senator has been set to 30 years of age in Article I, Section 3 of the United States Constitution. Since this legislation was passed in 1787 when a 40-year-old individual had been considered extremely seasoned, one can understand what the fourth president of the United States James Madison intended to say when he wrote about the qualities a senator in *The Federalist Papers*: “*A senator must be thirty years of age at least; as a representative must be twenty-five. And the former must have been a citizen nine years; as seven years are required for the latter. The propriety of these distinctions is explained by the nature of the senatorial trust, which, requiring a greater extent of information and stability of character requires at the same time that the senator should have reached a period of life most likely to supply these advantages (...)*”⁹

The Founding Fathers are not the only ones who recognized the qualities a person should possess to fill a post bearing high responsibility. Capital markets recognize it too. Even though there is no conclusive empirical evidence to substantiate that investors reward corporations with reputable management more than the ones with dubious management practices, it can be argued that the appointment of a good and reputable CEO is good for the stock price. One of the wealthiest men in the world, Mr. Warren Buffet said during Berkshire Hathaway’s annual meeting in 1994 that “*you can judge management by two yardsticks. One is how well they run the business, and I think you can learn a lot about that by reading about both what they’ve accomplished and what their competitors have accomplished, and seeing how they have allocated capital over time. (...) And then the second thing you want to figure out is how well they treat their owners.*”¹⁰

Analyzing large corporate failures after 2008, regulators tagged lack of professional competences and integrity of board members, supervisory board members, and high ranking managers, as one of the reasons that lead to bankruptcies and collapses. Just being an educated and successful manager with a few diplomas was not enough. It became necessary to meet other certain standards.

⁹ The *Federalist Papers* were written by Alexander Hamilton, John Jay and James Madison to promote ratifying the proposed text of United States Constitution. Full text is available in the *Federalist Paper #62* at: <https://guides.loc.gov/federalist-papers/text-61-70#s-lg-box-wrapper-25493449> accessed on 16/11/2020.

¹⁰ [<https://buffett.cnbc.com/video/1994/04/25/buffett-you-judge-management-by-two-yardsticks.html>] accessed on 16/11/2020.

Financial heavyweights failed in the past due to overleveraging and taking too much risk (e.g. Long-Term Capital Management in 1998, Lehman Brothers, Bear Stearns, AIG during the global financial crisis). That was a warning sign for the financial industry that the highest fit and proper standards and requirements for management board members had to be obligatory.

Nowadays, principles of sound management policies for listed companies are omnipresent across the globe. For example, the Croatian Corporate Governance Code prescribes that *“The management board shall have the necessary skills, knowledge, education, experience, and diversity to carry out its collective responsibilities effectively. Each individual member shall have the relevant expertise needed for their specific duties.”*¹¹, with the appointment procedure also being addressed (*“...formal and transparent procedures for the appointment of supervisory and management board members are in place...”*¹²).

However, the regulation became most rigid and efficient in preventing unsuitable candidates from becoming management board members in the financial industry. Criteria were set up to examine and evaluate the manager’s ability to fulfill their duties (“fitness”), as well as their integrity and suitability (“propriety”). Rules and criteria are prescribed as a risk indicator, to prevent individuals who can pose a risk to the functioning of the institution from being appointed.

Today most financial supervision mechanisms include these fit and proper requirements in their regulatory frameworks. Furthermore, regulators are in charge of assessing whether or not a candidate for the management board of a bank meets the requirements.

3. LEGAL FRAMEWORK IN CROATIA

3.1. GENERAL LEGAL FRAMEWORK IN CROATIA

Analyzing and comparing EU continental and Anglo-American company laws¹³, EU legal regulation is much more rigid and detailed in prescribing criteria for board members, while Anglo – American rely more on soft law and internal codes. The cornerstone of Croatian corporate legislation is Company

¹¹ Corporate Governance Code section 5, principle J [https://www.hanfa.hr/media/4097/zse_kodeks_eng.pdf], accessed on 17/11/2020.

¹² Ibid., section 3, principle E.

¹³ Save for British law, which has followed the EU regime.

Act¹⁴ that determined, the minimum criteria one must fulfill to be eligible as a board member is (i) to be a natural person and (ii) with a full legal capacity. Besides, a person is not proper whenever he/she:

- has had criminal punishment for the criminal act of bankruptcy abuse, criminal act of abuse in the bankruptcy proceedings, criminal act of preference of creditors, and/or criminal act of violation of the obligation of bookkeeping for the period of 5 years after the legal validity of the verdict (time during serving the sentence excluded)
- has been sentenced with security measure of the proscription of doing businesses included in the business activity of the company in the matter, for the due period of the subject measure.¹⁵

Hence, Company Act regulates fit and proper for company board members in a general and liberal manner, stipulating only general provisions which restrain a person with criminal conviction and security measure to perform as board members. This is only logical, bearing in mind that the majority of companies in Croatia are incorporated as the limited liability legal structure.

The company board and its members are obliged to act only and exclusively in accordance with the company's interest. They must execute their business using the *loyalty principle*.¹⁶ It is of high importance to emphasize that loyalty is required towards the company and its interest and not for the benefit of (majority) shareholders¹⁷, creditors nor third persons.¹⁸ Board members are obliged to act with due diligence. They are also required to perform in accordance with business judgment rule¹⁹:

- if the judgment is a business judgment
- if the board reasonably believes that the judgment is in the best interest of the company

¹⁴ Companies Act (NN 11/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09, 125/11, 152/11, 111/12, 68/13, 110/05, 40/19).

¹⁵ Ibid Article 239.

¹⁶ Prof. dr. sc. Hana Horak i Kosjenka Dumančić, mr.spec.: Neovisnost i nagrađivanje članova nadzornih odbora i neizvršnih direktora, Zbornik radova Pravnog fakulteta u Splitu, god. 48, 1/2011., page 38

¹⁷ Barbic, J: Osobe koje vode poslove kao odgovorne osobe i određenje predstavnika pravne osobe po zakonu o odgovornosti pravnih osoba za kaznena djela, Hrvatski ljetopis za kazneno pravo i praksu, Vol. 10 No. 2, 2003., page 782.

¹⁸ [<https://lider.media/preporuceno/jaksa-barbic-akademik-uprava-i-nadzorni-odbor-moraju-djelovati-u-interesu-drustva-a-ne-dionicara-123615>] accessed 17/11/2020.

¹⁹ Companies Act (NN 11/93, 34/99, 121/99, 52/00, 118/03, 107/07, 146/08, 137/09, 125/11, 152/11, 111/12, 68/13, 110/05, 40/19) Article 252.

- if the risk level is reasonable
- if the business judgment is made upon adequate information available
- if there is no conflict of interest whatsoever
- if it acts in *bona fide*²⁰

One of the main *ratios* behind fit and proper standards is to ensure a solid and measurable mechanism by which board members will align their interest with the principal's goals and not in the goals of other parties.

3.2. LEGAL FRAMEWORK IN THE FINANCIAL INDUSTRY

However, in the financial industry due to their potentially strong impact on the market as a whole legal framework regulates higher standards for appointing board members. In the EU, regulators standardized industries and their criteria for fit and proper assessment. Analyzing comparative legislation in the EU, all member countries implemented Guidelines' from EU regulators. The legal framework in the financial market is regulated for:

- Banks²¹
- Investment funds industry^{22,23}
- Insurance industry²⁴
- Stock exchange industry²⁵
- Leasing industry^{26,27}

²⁰ Barbić, J.: Pravo društava, knjiga druga, Organizator, Zagreb, 2013, p. 836.

²¹ Decision on fit and proper assessment of President of the board, Board members, members of Supervisory Board and key functions in credit institution, (Official Gazette of the Republic of Croatia NN no. 93/18)

²² Investment Funds with Public Offering Act, (Official Gazette of the Republic of Croatia NN no. 44/16, 126/19) .

²³ Alternative Investment Funds Act, (Official Gazette of the Republic of Croatia NN no. 21/18, 121/19).

²⁴ The Croatian Insurance Act, (Official Gazette of the Republic of Croatia NN no. 30/15, 112/18, 63/20, 133/20).

²⁵ Capital Market Act, (Official Gazette of the Republic of Croatia NN no. 65/18, 17/20).

²⁶ Leasing Act, (Official Gazette of the Republic of Croatia NN no. 141/13).

²⁷ Financial Services Supervisory Agency Rule on terms and conditions for board and supervisory board membership regarding leasing companies (Official Gazette of the Republic of Croatia NN no. 23/14, 72/17).

Special requirements are also stipulated for board members of the state-owned companies of special interest for the Republic of Croatia.²⁸ Croatian legislature requires additional prerequisites for board members in some other business domains, such as the sports industry.²⁹ It clearly shows that Croatian legislator has taken a stand that in certain business areas board members must cope with complementary standards.

Although current legislation criteria (Article 252 of the Company Act) should remain in force for the majority of companies and their boards, there is a reasonable demand to expand the fit and proper legislation framework on companies when specific performance and benchmarks are achieved. Maybe the answer can be found within other complementary laws. In the given example, under the Accounting Act³⁰, the classification of businesses is done using the following criteria:

- Assets
- Income
- Employees

Based on the aforementioned criteria, there are 4 groups of businesses: micro, small, medium, and large businesses³¹:

company size	MICRO	SMALL	MEDIUM	LARGE
criteria	qualifies by not exceeding more than one condition	not micro & not exceeding more than one condition	not micro nor small & not exceeding more than one condition	qualifies by exceeding two or more conditions
Assets	HRK 2.6 million	HRK 30.0 million	HRK 150.0 million	HRK 150.0 million
Income	HRK 5.2 million	HRK 60.0 million	HRK 300.0 million	HRK 300.0 million
Average number of workers	10	50	250	250

²⁸ Gulation on terms and conditions for board and supervisory board membership regarding companies of significant state interest (Official Gazette of the Republic of Croatia NN no. 12/19).

²⁹ Sports Act, (Official Gazette of the Republic of Croatia NN no. 71/06, 150/08, 124/10, 124/11, 86/12, 94/13, 85/15, 19/16, 98/19, 47/20, 77/20).

³⁰ Accounting Act, (Official Gazette of the Republic of Croatia NN no. 78/15, 134/15, 120/16, 116/18, 42/20, 47/20).

³¹ Ibid. Article 5.

The Accounting Act sets up different legal frameworks for each type of business regarding auditing, timeframe for keeping documents, reporting standards, annual reports, financial statements, etc.

The following businesses are obliged to audit financial statements: public entities, all companies that have submitted a request for listing their securities on a regulated market and medium and large businesses, parent companies of medium and large groups. In accordance, subject to audit are all joint-stock companies, partnerships, and limited liability companies whose separate or consolidated data in the year preceding the revision exceeds at least 2/3 of the following criteria:

- Total assets - HRK 15.000.000,00
- Net income - HRK 30.000.000,00
- Average number of employees during the business year - 25

Similar to that, the Company Law requires a supervisory board for all joint-stock companies. For limited liability companies, a supervisory board is mandatory, unless certain criteria are matched among others, those criteria are (alternatively):

- Average number of employees during the business year - 200
- Share capital greater than HRK 600.000 and more than 50 members

The two latter examples evidently show that Croatian legislator both distinguish companies and sets additional obligations to different types of companies, based on set criteria. Setting rules this way is a strong argument to wider the fit and proper legislative framework for businesses when certain indicators are achieved. Since large companies have the biggest impact on the market, it might be appropriate to regulate them as an example of good corporate governance in the upcoming fit and proper assessments.

3.2.1. LEGAL FRAMEWORK IN THE BANKING INDUSTRY

The legal framework for assessing the suitability of key management personnel in Croatia has existed since at least 1999³² and has been evolving continuously ever since. It is currently set by the Croatian National Bank's Decision on the assessment of the suitability of the President of the Management Board, a member of the Management Board, a member of the Supervisory Board, and

³² Croatian National Bank's Rule on the procedure and criteria on consent for appointing bank board members (Official Gazette of the Republic of Croatia NN no. 32/99).

the holder of a key function in a credit institution (here and after Decision)³³. This framework prescribes strict rules and requirements a candidate for key management positions in banks must meet, ranging from relevant working experience and type of functions a candidate held to the knowledge a candidate has acquired in that function, candidate's reputation and honesty, etc.

Candidates are appointed to the position in a Management Board or Supervisory Board of a credit institution in Croatia only after the prior approval to perform the function is granted by the Croatian National Bank. Meanwhile, as a part of the process of establishment of close cooperation between Croatian National Bank and ECB, ECB has taken over direct supervision over 6 banks and 2 building societies in Croatia since October 01, 2020³⁴, thereby joining other institutions that fall under the ECB supervision and decision making with regard to the appointment to the management bodies of this institutions. In this sense, the ECB has exclusive responsibility for the field of fit and proper supervision for the institutions that fall under its jurisdiction. However, concerning the legal framework, there will not be material changes considering that the ECB will apply the substantive fit and proper requirements laid down in the binding national law which implements the Article 91 of the Directive 2013/36/EU ("CRD IV"; Capital requirements directive IV), on top of which the joint ESMA and EBA Guidelines will be applied as well³⁵.

4. FIT AND PROPER ASSESSMENT

The matter of corporate governance is not just organizational culture and professional ethics but it is difficult to effect Board member's personal view on honesty, fairness, social sensitivity, and responsibility because it is always in the domain of personal character.³⁶ One of the control roles of the Supervisory Board is to ensure transparency of Board member's appointments.³⁷ It, therefore, plays a crucial role in the taking of the important corporate decision.³⁸

³³ Decision on fit and proper assessment of President of the board, Board members, members of Supervisory Board and key functions in credit institution, (Official Gazette of the Republic of Croatia no. 93/18).

³⁴ [<https://www.hnb.hr/en/-/esb-objavio-popis-bugarskih-i-hrvatskih-banaka-koje-ce-izravno-nadzirati-od-listopada-2020->] accessed 17/11/2020.

³⁵ ECB's Guide to fit and proper assessment: [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf] accessed 16/11/2020.

³⁶ Barbić, Čolaković i Novoselec; *Odgovornost Direktora, Kaleidoskop*, Zagreb 2012. p. 32.

³⁷ Darko Tipurić i suradnici, *Korporativno upravljanje, Sinergija*, Zagreb, 2008 p. 395.

³⁸ Davis, Hopt, Nowak, Van Solinge: *Corporate boards in Law and practice*; Oxford press 2013. p.4.

Proscribed criteria are a very good guideline for Supervisory Board in evaluating a candidate's character before the appointment. The purpose of fit and proper assessment is to ensure that companies have knowledgeable and solid management. Senior management who hold influence over the entity's key operations must also meet the "fit and proper" criteria. Through fit and proper assessment process it must be positively clear that appointed directors, other than basic, fulfill integrity requirements.

After comparison of regulation in the financial industry, most regulated is the Banking sector. Therefore, this paper presents requirements and processes that banks have to take into consideration, such as experience, integrity, analyze aspects such as criminal records, financial position, sanctions applied by regulators, sanctions applied by regulators of other similar industries, questionable business practices, and rejection from professional associations. Fit and proper requirements take into consideration formal qualifications, previous experience, integrity, and suitability to analyze aspects such as criminal records, financial position, and civil actions against third parties. They are set to support the Supervisory Board in the evaluation process and to prevent appointments in the first place and also from continuing the management role if any problem regarding managers fit and proper evaluation arises during his mandate.

Board members will be expected to remain competent for the positions they will hold. Failure to maintain the requested qualifications would raise doubts about the person's fitness. In that case, the fit and proper assessment would have to be reviewed by the company and by the Regulator.

The Person's character, competence, and experience relative to the duties involved, including if the person:

1. has sufficient skills, knowledge, competence, diligence, and soundness of judgment to undertake and fulfill the particular duties and responsibilities of the position in question³⁹
2. has demonstrated the appropriate competence and integrity in fulfilling professional responsibilities previously during his/her career.⁴⁰

Fit and proper requirements are an issue not just at the moment of appointment, but on an ongoing basis. Industry professionals are expected to be in full compliance with their contract of employment. This would include compliance with the company's internal code of ethical behavior. Where there has been

³⁹ Fit and Proper Assessment – Final Report; International organization of Securities Commissions December 2009 [<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD312.pdf>], page 11. accessed 16/11/2020.

⁴⁰ Ibid.

wrongdoing, the Regulated Institution may make all reasonable efforts to establish grounds for taking disciplinary action and where appropriate take the action. In any case, where such matters come to light, they may be reported immediately to the Regulator. The person is not proper whenever he/she:

1. has demonstrated a lack of willingness to comply with legal obligations, regulatory requirements or professional standards, or has been obstructive, misleading or untruthful in dealing with regulatory bodies or a court;
2. has breached a fiduciary obligation;
3. has perpetrated or participated in negligent, deceitful, or otherwise discreditable business or professional practices;
4. has been reprimanded, or disqualified, or removed by a professional or regulatory body concerning matters relating to the person's honesty, integrity, or business conduct;
5. has seriously or persistently failed to manage personal debts or financial affairs satisfactorily in circumstances where such failure caused loss to others;
6. has been substantially involved in the management of a business or company which has failed, where that failure has been occasioned in part by deficiencies in that management;
7. is of bad repute in any business or financial community or any market;
8. was the subject of civil or criminal proceedings or enforcement action, in relation to the management of an entity, or commercial or professional activities, which were determined adversely to the person (including by the person consenting to an order or direction, or giving an undertaking, not to engage in unlawful or improper conduct) and which reflected adversely on the person's competence, diligence, judgment, honesty or integrity.⁴¹

4.1. PROCESS OF FIT AND PROPER ASSESSMENT FOR BANKS IN THE EUROPEAN UNION AND CROATIA

The most advanced legislative framework in the field of fit and proper assessment is in the banking industry. As such, this article will explain the process and exact criteria that need to be fulfilled for fit and proper assessment. Criteria and procedure of assessment are based on Joint ESMA and EBA Guidelines

⁴¹ Fit and Proper Assessment – Final Report; International organization of Securities Commissions December 2009 [<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD312.pdf>] page 11. and 12 accessed 16/11/2020.

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/EU⁴².

4.2. PRINCIPLES

Fit and proper assessment is required for members of the board, supervisory board, and key functions. According to the Decision's article 17, key functions are all control functions, head of internal control, risk and compliance, Anti-money laundering officer, Head of corporate, retail, finance, treasury, and others that have a significant impact on managing the bank. The process of fit and proper assessment is strictly formal and based on 6 principles.⁴³

Principle 1 – Primary responsibility of credit institutions

Credit institutions have the primary responsibility of selecting and nominating individuals for the management body who comply with the requirements for fitness and propriety ("suitability"). They must carry out their own due diligence and assessment of the members of the management body, not only before the appointment but also on an ongoing basis (e.g. in the case of a significant change to the responsibilities of a member of the management body). In doing so, the companies must ensure that they have the fully transparent cooperation of the individuals concerned. As part of its responsibility to ensure the (ongoing) suitability of the members of the management bodies, companies must provide the competent authorities with all the information necessary for the fit and proper assessment in all cases (new appointment, new facts, change of role, etc.). Supervisors (for banks those are national central banks) decide on what information must be provided and how in accordance with the applicable EU and national law, as well as with the joint ESMA and EBA Guidelines on suitability. If a company or appointee does not comply with this requirement, the information on the appointee is considered to be incomplete, which renders it impossible to take a positive decision.⁴⁴

⁴² [[https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20\(EBA-GL-2017-12\).pdf](https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20(EBA-GL-2017-12).pdf)] accessed 16/11/2020.

⁴³ [[https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20\(EBA-GL-2017-12\).pdf](https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20(EBA-GL-2017-12).pdf)] accessed 16/11/2020.

⁴⁴ Ibid.

Principle 2 – Gatekeeper

Fit and proper supervision must prevent individuals who would pose a risk to the proper functioning of the management body from entering in the first place or from continuing in their role when an issue regarding their fitness and propriety has arisen. The responsibility of the regulator in this respect is to act as a gatekeeper.⁴⁵

Principle 3 – Consistency

The Regulators fit and proper supervision seeks to ensure consistency in the assessments of management body members across the euro area. The ECB, as a European regulator, will ensure consistency and convergence in suitability assessments to the extent allowed by the applicable EU and national law.⁴⁶

Principle 4 – Proportionality and case-by-case assessment

The principle of proportionality applies throughout the whole fit and proper process, meaning that the supervisory process of the regulator, as well as the application of the suitability criteria, should be commensurate with the size of the entity and nature, scale and complexity of its activities, as well as the particular role to be filled. The application of the proportionality principle to the suitability criteria cannot lead to a lowering of the suitability standards, but can result in a differentiated approach to the assessment procedure or the application of suitability criteria (e.g. in terms of the level or areas of knowledge, skills, and experience, or in terms of the time commitment required of members of the management body in its management function and members of the management body in its supervisory function). Therefore, in all cases, the assessment will come down to an individual analysis and supervisory judgment.⁴⁷

Principle 5 – Principles of due process and fairness

Fit and proper supervision is strongly procedurally driven. However, the rights of both the supervised entity and the appointee could be affected by a fit and proper decision. The Regulator has a duty to decide based on information that

⁴⁵ Ibid.

⁴⁶ [[https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20\(EBA-GL-2017-12\).pdf](https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20(EBA-GL-2017-12).pdf)] accessed 16/11/2020.

⁴⁷ Ibid.

can be considered as material and relevant to the fit and proper assessment, in a balanced way, weighing up the factors that speak in favor of and against the appointee. Fit and proper assessments, as any supervisory procedure, are strictly confidential.⁴⁸

Principle 6 – Interaction with ongoing supervision

The fit and proper assessment feed into the ongoing supervision of the governance of an institution, especially concerning the composition and functioning of the management body. A fit and proper assessment may lead to a decision that needs to be followed up in ongoing supervision, while ongoing supervision, in turn, may provide input for a fit and proper assessment (especially about the collective suitability or independence of mind criteria) or lead to the reassessment of members of the management body.⁴⁹

4.3. CRITERIA

Key criteria for fit and proper assessments are under the respective national laws implementing the Capital Requirements Directive. The appointees are assessed using the five fit and proper criteria set out in Article 91 of the CRD IV:⁵⁰

1. Knowledge, skills, and experience
2. Reputation – including possibilities of candidates pending legal proceedings, a criminal record, or any kind of administrative or tax irregularities
3. Conflict of interest – covering the potential possibility of the candidate to be able to act free of external influences when making decisions or might personal interest cloud his objective decision-making
4. Time commitment – sufficient devotion to his duties as director
5. Collective suitability of the board (for Management and Supervisory Board) – evaluating a particular candidate for the board as a whole and how does the candidate fit in with his knowledge, skills, and experience

⁴⁸ Ibid.

⁴⁹ [[https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20\(EBA-GL-2017-12\).pdf](https://eba.europa.eu/sites/default/documents/files/documents/10180/1972984/43592777-a543-4a42-8d39-530dd4401832/Joint%20ESMA%20and%20EBA%20Guidelines%20on%20the%20assessment%20of%20suitability%20of%20members%20of%20the%20management%20body%20and%20key%20function%20holders%20(EBA-GL-2017-12).pdf)] accessed 16/11/2020.

⁵⁰ Ibid.

4.3.1. KNOWLEDGE, SKILLS, AND EXPERIENCE

Members of the management body must have sufficient knowledge, skills, and experience to fulfill their functions⁵¹. Required experience is proscribed in national legislations and covers both practical, professional experience gained in previous occupations and theoretical experience (knowledge and skills) gained through education and various training. Croatian National Bank proscribed required education and skills in Decision on the assessment of the suitability of the President of the Management Board, a member of the Management Board, a member of the Supervisory Board, and the holder of a key function in a credit institution⁵².

The Decision counted all conditions required for a person to be fit and proper. It requires a person to have graduate study in the fields of economics (management, finance, accounting), law, mathematics, physics, IT, or engineering. Besides formal education, the person has to be skilled and educated in financial markets, auditing, regulatory environment, strategic planning, risk assessment, corporate governance including internal controls and financial data analysis.

Appropriate working experience is overviewed in the last 10 years before person candidates for the position. The required experience will be evaluated through at least 3 years of continuity as a board member or head of the organizational unit in the bank that is crucial for business. Exceptionally experience will be evaluated through 5 years if a person was working in the financial sector besides banks or regulators. Besides formal criteria's further assessment will require the type of function and position in the company's hierarchy, type of complexity of work performed by a person, the scope of decision-making powers and responsibilities, and a number of subordinate workers.

4.3.2. REPUTATION

It's crucial for Members of the management body at all times to have a good reputation so that they can ensure prudent management. A person will be considered to be of good reputation if there is no evidence to suggest otherwise and no reason to have reasonable doubt about his or her good repute. If the

⁵¹ DIRECTIVE 2013/36/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, Article 91 (1).

⁵² Decision on fit and proper assessment of President of the board, Board members, members of Supervisory Board and key functions in credit institution, (Official Gazette of the Republic of Croatia NN no. 93/18).

personal or business conduct of a person gives rise to any doubt about his or her ability to ensure sound and prudent management, it has to be evaluated. This is also important from the perspective of reputation risk for the company.

Circumstances that jeopardize reputation criteria are:

- pending legal proceedings, as well as criminal or administrative proceedings, or other analogous regulatory proceedings and will have an impact if the decision goes against the person
- managed a company at the time when it was convicted for a criminal offense
- insolvency procedure begun while a person was responsible for the management
- who has not proven during previous professional work and personal integrity
- whose business results endanger the reputation, integrity, and conscientiousness of the candidate
- whose financial stability jeopardizes the reputation, integrity, and conscientiousness of the candidate
- other reason to suspect that a person has no reputation, honesty, and conscientiousness.⁵³

While legal proceedings are widely proscribed, pending cases should be thoroughly analyzed and taken into consideration. It is important that they are relevant to the reputation. ESMA and EBA Guidelines on suitability define concerning legal proceedings and criminal investigations are considered relevant to conduct the assessment:

- the nature of the charge or accusation (including whether the charge is criminal, administrative in nature or involves a breach of trust); the phase of proceedings reached (i.e. investigation, prosecution, sentence, appeal); and the likely penalty if a conviction ensues;
- the time that has passed and the conduct since the alleged wrongdoing;
- the personal involvement of the appointee particularly concerning corporate offenses;
- any understanding of and/or insight into his or her conduct gained by the appointee over time;

⁵³ [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf] accessed 18/11/2020

- other mitigating or aggravating factors (e.g. other current or past investigations, administrative sanctions imposed, dismissal from employment or any position of trust, etc.);
- assessment of the facts.⁵⁴

4.3.3. CONFLICT OF INTEREST AND INDEPENDENCE OF MIND

Directors, being the company's agents, must primarily act in the best interest of the company.⁵⁵ The rise and role of independent directors go back to the USA and is today a common feature of corporate governance and codes.⁵⁶ A conflict of interest occurs when an individual becomes unreliable because of a clash between personal (or self-serving) interests and professional duties or responsibilities. Disclosure, assessment, mitigation, management, and prevention of conflicts of interest Members of management bodies should be able to make their own sound, objective, and independent decisions and judgments. Independence of mind can be affected by conflicts of interest.⁵⁷

Companies should have governance policies in place for identifying, disclosing, assessing, mitigating, managing, and preventing conflicts of interest, whether actual, potential or perceived.

Having a conflict of interest does not necessarily mean that a person cannot be considered suitable. This will only be the case if the conflict of interest poses a material risk and if it is not possible to prevent, mitigate, or manage the conflict of interest. A key aspect of the operation of the conflict rule in all fiduciary relationships has been the option of informing by the principal following full disclosure of the conflict.⁵⁸

In accordance with the joint ESMA and EBA Guidelines on suitability, if a conflict of interest is considered to be material, the company must adopt adequate measures, namely, it must:

⁵⁴ [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf] accessed 18/11/2020

⁵⁵ Tipurić, D.: *Nadzorni odbor i korporativno upravljanje*, Zagreb, 2006, p.

⁵⁶ Davis, Hopt, Nowak, Van Solinge: *Corporate boards in Law and practice*, Oxford press p.28.

⁵⁷ Ibid.

⁵⁸ Rosemary Teele Langford; *Company Director's duties and conflict of interest*, Oxford press 2019, p 78.

- perform a detailed assessment of the particular situation;
- decide which preventive/mitigating measures will be implemented, primarily based on its internal conflicts of interest policy unless national law already prescribes which measures must be taken⁵⁹

According to the joint ESMA and EBA Guidelines on suitability, the company should explain in a “Conflict of interest statement” how the conflict of interest is being prevented, mitigated, or managed.⁶⁰

A too-strict approach to controlling private interests may conflict with other rights or be unworkable or experienced and competent candidates might avoid a certain position. An approach to conflict-of-interest policy seeks to strike a balance and manage the conflict of interest. Measures for managing the conflict of interest might be:

- prohibition to participate in any meeting or decision-making concerning a particular disclosed interest;
- resignation of a certain position;
- specific monitoring by the supervised entity;
- specific reporting to the competent authority on a particular situation;
- cooling-off period for the appointee;
- obligation on the supervised entity to publish the conflict of interest;⁶¹
- If the measures taken by the company are not sufficient to adequately manage the risks posed by the conflict of interest, the person cannot be considered suitable and *pas fit* and proper assessment.

4.3.4. TIME COMMITMENT

Every person who wants to be appointed as a member of the management body must be able to commit sufficient time to perform their duties in the company. When evaluating time commitment, quantitative and qualitative requirements should be taken into consideration.

The time a person can dedicate to specific functions can be affected by several factors, such as:

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf] accessed 18/11/2020.

- the number of directorships held;
- the size and the situation of the entities where the directorships are held and the nature, scale, and complexity of the activities;
- the place or country where the entities are based;
- other professional or personal commitments and circumstances (e.g. a court case in which the appointee is involved)⁶²

Quantitative assessment of time commitment is one of the most important factors. While Company Act, article 225.2.2. in Croatia sets the limit on a maximum of 10 supervisory boards, regulations for fit and proper are stricter. A regulation limited number of director positions to one executive directorship with two non-executive directorships, or four non-executive directorships. However, there are two exceptions to this rule:

1. Directorships in organizations that do not pursue predominantly commercial objectives do not count, but they need to be declared as part of the fit and proper notification.
2. Certain multiple directorships count as a single directorship (“privileged counting”):
 - a. directorships held within the same group;
 - b. directorships held within institutions that are members of the same institutional protection scheme;
 - c. directorships held within entities in which the institution holds a qualifying holding.⁶³

Qualitative assessments of time commitment are qualitative factors that determine the amount of time a person can dedicate to the function, such as

- the size and the circumstances of the entities where the directorships are held and the nature, scale, and complexity of their activities;
- the place or country where the entities are based;
- other professional or personal commitments and circumstances (e.g. a court case in which the appointee is involved);
- the travel time required for the role;
- the number of meetings scheduled for the management body;

⁶² Ibid.

⁶³ https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf accessed 18/11/2020.

- the time needed for necessary induction and training;
- the nature of the specific position and the responsibilities of the member (e.g. specific role as CEO or Chair, or membership of a committee).⁶⁴

The fit and proper person must be able to commit sufficient time to perform his functions. The company should also need ongoing learning and development, as well as the need for a buffer for unexpected circumstances.⁶⁵

4.3.5. COLLECTIVE SUITABILITY OF THE BOARD

Individual suitability assessments are intended to target the complete spectrum of hard and soft skills that directors need to have for performing their duties. Individual suitability assessments also serve as an input for the collective suitability of companies' boards. These days knowledge for running companies must be widely spread from finance, IT, regulatory, etc., so different skills are required for successful management. That is why collective suitability for boards in financial institutions is obligatory.

The assessment of collective suitability should provide a comparison between the actual composition of the management body and the management body's actual collective knowledge, skills, and experience. Companies should perform an assessment of the collective suitability of the management body using either the suitability matrix template developed by the company taking into account the individual risk profile and business model or their own appropriate methodology in line with the criteria such as size, internal organization, and nature, scale, and complexity.

Suitability assessments can add much more value to corporate governance than just achieving regulatory compliance. A board that is various in knowledge and has collective suitability can support companies in managing the full spectrum of risks they face, and bring minds to the table that can meet their ambitions and address emerging challenges in this new era of disruption.

4.4. PROCESS OF FIT AND PROPER ASSESSMENT

In business practice for Croatian banks, there are usually three situations when a suitability assessment is carried out:

1. before an application is made for granting prior approval from the CNB for appointment of a management board member ("candidate assessment"),

⁶⁴ Ibid.

⁶⁵ Ibid.

2. regular yearly assessment of the management board member,
3. extraordinary assessment when a circumstance arises due to which an assessment has to be carried out.

A candidate is obliged to deliver all necessary information to the institution, where an internal working group/committee carries out the assessment.

The assessment completed by the working group is then examined by the supervisory board and appointments committee, before being sent to the CNB together with the candidate's personal information (training & educational background, working experience, etc.), recommendations by superiors, information about litigation against the candidate (if it exists), candidate's financial stability and information about proceedings that might adversely affect his/her financial stability, information about financial & non-financial interests, etc. Apart from this, a candidate appointed as the CEO should prepare a work program that is to be presented to the CNB which issues prior to approval⁶⁶.

A yearly assessment of the management board members is carried each year in order to confirm a management board member's suitability after taking office, as well as the suitability of the management board as a whole, collectively. This periodical assessment ensures conditions for permanent and continuous suitability of the management board members, or alternatively – enables the institution's relevant bodies to enact necessary measures.

If a circumstance arises that casts doubt over the individual or collective suitability of board members, especially concerning their reputation and honesty, an extraordinary assessment of board member's suitability should be carried out. Such a procedure can in the event of a serious infringement result in a dismissal of a board member, but in other cases, only corrective measures would be initiated.

5. CONCLUSION

Throughout the analyzed legislation framework in Anglo-American and EU laws, The financial industry is without a doubt the leader in comprehensive and strict regulations. Sarbanes – Oxley Act⁶⁷, enacted in the aftermath of Enron and WorldCom scandals, brought huge benefits to the investment community in the United States through requirements for disclosure of information that might enable investors to deduce whether or not a corporation's corpo-

⁶⁶ ECB has taken over direct supervision over 6 banks and 2 building societies in Croatia since October 01 2020. For more information see note 31

⁶⁷ [<https://www.govinfo.gov/link/plaw/107/public/204?link-type=pdf&.pdf>] accessed 17/11/2020

rate governance or financial reporting is shady. On the other hand, tightening of standards for banks' management board suitability in Europe during the 2010s minimized bank failures. Now there is a gap between regulation of the financial sector and other sectors, although the matter of Board members appointment is not specific for the financial industry, but a common matter for all companies.

These examples show us that criteria for appointing Board members, as leaders of companies, should be standardized in business practice. It has been shown that strict criteria for the appointment of Board members minimized the risk of company failures on the market. Even though this research shows us that one size does not fit all, and that is challenging to standardize criteria throughout different industries, for further implementation of fit and proper assessment it should be taken into account in all sectors. The criteria for stipulating fit and proper standards could be set generally as the benchmark and proscribed in Companies law and specific requirements for different sectors can be part of soft law, and become standards for each industry. That kind of filter contributes to the best interests of the company and all stakeholders.

However, regulation can sometimes be demanding for business. It can reasonably be argued that tighter fit and proper criteria can, on top of a legislative framework already established (e.g. corporate governance codes for listed companies), contribute to capital protection. The potential legislative stipulation of fit and proper criteria based on measurable financial and market-related performance indicators (e.g. Accounting Act example) would raise the level of the board members' selection quality for companies meeting the subject conditions. Expanding the fit and proper legislation framework on companies currently outside of it is a solid prerequisite for lowering the margin for error during market turmoil. By using best practices from the financial industry together with businesswise non-limiting yet market protective criteria would surely create benefits for both internal stakeholders and the market itself. Through the practice of taking over good practices from the financial sector so far, it can be expected that in the future fit and proper assessment will become a mandatory element for all Board members' appointments.

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