

Tougher at the top

Senior financial services executives in the UK are now set to face an unprecedented level of personal liability for the conduct of the businesses they manage. **Ellen Gallagher** and **Alex Irvine** take a look at the changing landscape for those occupying the highest ranks of the industry

There has never been a more challenging time to hold a senior position in the financial services industry. From "Fred the Shred" and Bob Diamond to Paul Flowers, senior executives have increasingly been targeted by regulators and politicians and vilified by the media for their alleged roles in causing or allowing misconduct in their organisations. In scandals ranging from misselling and benchmark manipulation to the collapse of financial institutions, the search for a human face to attach to the failings of an entire organisation has very often ended at the door of the boardroom.

Yet such public condemnation has rarely translated into regulatory action. The June 2013 report of the Parliamentary Commission on Banking Standards (PCBS) described an "accountability firewall": a regulatory framework which encouraged Nelsonian blindness on the part of banking leaders, protecting from regulatory sanction those who remained ignorant of their organisation's failings and encouraging them not to enquire too deeply into its frontline activity lest they entangle themselves in wrongdoing.¹

The conclusion that the regulator's tools were not equal to the job of targeting senior individuals led inexorably to the recommendation that its powers be enhanced and the whole regime of regulating senior persons be remodelled to enable those at the apex of a firm's management to be fixed with direct responsibility for misconduct engaged in much further down the chain of command and, moreover, for any faults in the structure which permitted it to take place.

New "Senior Managers Regime"

The legislative response to these recommendations is contained in the Financial Services (Banking Reform) Act 2013 ("the Act") due to come into force once the Financial Conduct Authority (FCA) consultation has been completed. The new "Senior Managers Regime" which it introduces will apply to senior personnel in certain financial services

firms in place of the "Approved Persons Regime", which will continue to apply to those not deemed to be Senior Managers. The new regime will initially apply only to Senior Managers of deposit takers and firms permitted by the Prudential Regulation Authority (PRA) to deal in investments as principal. However, the FCA's response to the PCBS² emphasises that the extension of the new regime to the wider financial services industry is under consideration.

The Senior Managers Regime will apply to all individuals that hold a Senior Management Function (SMF).³ A SMF is broadly one

which requires an individual to be responsible for managing one or more aspects of the affairs of the firm involving a risk of serious consequences for the firm or "other interests in the United Kingdom". "Management" here includes "participating in the taking of decisions" – the emphasis on participation in decision making is intended to make enforcement action against senior individuals easier when presented with collective decision making by a board or other senior committee.

Which specific functions will be designated SMFs is yet to be determined by the FCA and PRA. It is not known whether the definition of SMF will be coextensive with that of

Significant Influence Functions under the existing Approved Person Regime.

The Act places renewed emphasis on relevant authorised persons satisfying themselves that candidates applying to hold SMFs are "fit and proper person[s] to perform the function".⁴ When making such an assessment, relevant authorised persons should have regard to whether the candidates have the necessary qualifications, competence and "personal characteristics" to perform the role. The precise meaning of the highly nebulous phrase "personal characteristics" is likely to be of concern.

Applications for approval for an individual to hold a SMF must be accompanied by a "statement of responsibilities" which sets out the aspects of the affairs of the firm that it is intended the applicant >>

“An incoming Senior Manager will likely require a thorough review of the business area for which he is taking over responsibility. The cost of the exercise will be significant and may highlight failings to the regulator with the inevitable risk of enforcement action”

will be responsible for.⁵ Care and precision will be needed to ensure that the individual's responsibilities are clearly defined, and that statements of responsibility marry up with the firm's governance and reporting structures. This demonstrates a clear move away from the current "gateway" approach to approval, to an ongoing process of monitoring and review.

Increased personal liability

The Act extends the limitation period for bringing enforcement action against individuals from three to six years.⁶ This will apply equally to those covered by the Approved Persons and Senior Managers Regimes. The consequence for an outgoing Senior Manager is that they will face significant personal liability long after having left the role. Furthermore, an incoming Senior Manager will likely require a thorough review of the business area for which he is taking over responsibility. The cost of the exercise will be significant and may highlight failings to the regulator with the inevitable risk of enforcement action.

Significantly, the Act also reverses the burden of proof applicable to Senior Managers⁷, who will be presumed liable for a contravention by the firm of a relevant requirement if they were at the relevant time responsible for the management of any of the firm's activities in relation to which the contravention took place. This presumption can only be rebutted if the accused person can satisfy the FCA that he or she took all reasonable steps to prevent the misconduct.

In addition, although not part of the Act, the FCA has, in its response to the PCBS, mooted the idea of introducing a "handover certificate" procedure.⁸ When leaving his or her role a Senior Manager would be required to describe how they have met their responsibilities under the regime and set out any issues that the person taking on those responsibilities should know about. Handover certificates are likely to present practical difficulties in determining what steps need to be taken when a person performing a SMF leaves and it is not clear quite how they will fit with the FCA's view that incoming senior persons are under a duty to perform an "Initial Assessment".⁹

Criminal mismanagement

Beyond their increased exposure to civil liabilities, those who preside over the failure of financial institutions will soon face criminal liability under s36 of the Act.

The new offence applies to persons performing a SMF role in a deposit-taking or PRA-regulated firm dealing in >>

inBrief

- Following criticism by the PCBS, the regulatory regime covering senior persons of deposit takers and firms permitted to deal in investments as principal has been enhanced
- The new regime may be extended to the wider financial services sector
- the new regime includes increased personal liability for senior individuals, which may extend long after they have left the role
- Those who preside over the failure of financial institutions will also face criminal liability.

investments as principal. The offence is committed when a Senior Manager takes or agrees to the taking of a decision which causes the failure of a firm within his or her group, or fails to prevent such a decision being taken. In addition, the Act requires the prosecution to prove:

- that the individual was aware of the risk that the implementation of the decision may cause the failure of the firm; and
- that his or her conduct fell far below that which could reasonably be expected of a person in his or her position.

This presents obvious evidential obstacles for the prosecution. The identification of a chain of causation linking a particular decision, or even a series of decisions, to a scenario as complex as the collapse of a bank will be challenging.

The introduction of an obligation to prevent certain decisions from being taken means that board members will be unable to avoid liability simply by sitting back and allowing others to make the tough calls. This provision also appears to be aimed at making it easier for prosecutors to target senior executives who may have created an environment which allowed or encouraged wrongdoing further down the ranks yet remained sufficiently distant from the relevant misconduct to avoid liability. However, the prosecution must demonstrate that the individual was aware that the relevant decision risked causing the collapse of the firm. In practice, this subjective test may be difficult to meet in all but those cases where clear warning signs have been ignored.

Attestations

In addition to the new regulatory and criminal powers which the Act will introduce, the FCA and its predecessor have, more informally, developed other means of focussing the minds of senior persons — in particular, by requesting that they personally "attest" to the regulatory health of their organisations, or particular aspects of it.

In recent years, senior individuals (predominantly CEOs) have increasingly been asked to provide such "attestations", stating that certain conditions have been, or will be, met by their organisations and thereby placing themselves firmly on the hook for any failings subsequently discovered.

Attestations have been requested after concerns have been identified at supervisory visits, as part of thematic reviews of particular sectors, or in connection with (or as an alternative to) enforcement action. Particularly in the latter context, the provision of an attestation might initially appear to be a convenient mechanism for the avoidance of further regulatory scrutiny. However, before staking their professional reputation by signing on the dotted line, senior persons must conduct proper due diligence to ensure the veracity of the statements they are making and should exercise great caution in delegating responsibility for that task. If it is later found to be false, an attestation may in fact prove to be the basis for enforcement action rather than a means of avoiding it, with the individual exposed to personal liability for breaches of Statements of Principle 1 and 4.

Despite having no legal power to require individuals to provide attestations, the FCA continues to use the language of "requirement" in relation to them: *"We will continue to require individuals to attest that remedial actions have been completed, or that other controls are fit for purpose, and this 'individual attestation' will be a key part of our approach to Senior Persons"*.¹⁰

The status of attestations is therefore nebulous and, while there is certainly no legal requirement to provide one, senior persons may find that they come under significant pressure to do so, not least from their own board. This is particularly relevant where the provision of an attestation might save the organisation from undergoing a s166 report

or enforcement action. There is a potential conflict of interests here and individuals finding themselves in this situation would do well to seek independent advice on their exposure.

A recent Freedom of Information Act 2000 (FoIA) request has shed some light on the use of attestations. The FCA's response to the request, albeit heavily redacted, outlines guidance provided to the FCA Supervision Division. Three key points arise from this guidance.

First, it is down to the discretion of the individual supervisor to select the most suitable person to make the attestation. Second, the wording of attestations is something to be negotiated between the supervisor and the firm. Third, when an attester leaves the firm, FCA supervisors will be looking for a successor to re-attest.

An appeal to the Information Commissioner has been made to gain access to the unredacted document. Email either of the authors of this article for a copy of the full FoIA request.

In practice

Many of the Act's provisions are a good deal more subtle than they might first appear. If enforced robustly, it is likely that they will present resource implications for institutions.

For the Senior Manager, while the number of cases in which the new offence could be made to stick may be rather small, the additional personal liability introduced by the Act, together with the FCA's increasing reliance upon the attestation in pursuit of its stated aim to foster a culture of personal accountability among senior executives, is a concerning development. The strong public desire to see individual accountability for corporate failures means that this trend is set to continue. ■



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1. pp.125-6, "Changing Banking for Good", PCBS, published June 2013
2. The FCA's response to the PCBS, October 2013
3. Section 59ZA FSMA, as amended by the Act
4. Section 60A FSMA, as amended by the Act
5. Section 60 FSMA, as amended by the Act
6. Section 66(5) and 66(5ZA) FSMA, as amended by the Act
7. Section 66A(6) FSMA, as amended by the Act
8. Paragraph 8, The FCA's response to the PCBS, October 2013
9. John Pottage v FSA, FS/2010/33, Upper Tribunal (Tax and Chancery Chamber) 20 April 2012
10. Section 1, paragraph 10, The FCA's response to the PCBS, October 2013