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Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
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By post and by email (financial.reform@hmtreasury.gsi.gov.uk)

5th October 2012

Dear Sir,

Re: Sanctions for the directors of failed banks

The City of London Law Society ("CLLS") represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response in respect of the consultation on *Sanctions for the directors of failed banks* has been prepared by the CLLS Financial law Committee.

We are pleased to have the opportunity to respond to this consultation and very grateful for being allowed additional time to do so. We set out two general observations and then deal with the consultation questions in the order set out in the consultation.

General observations

1. Definition of "failed bank"

There is no clear indication of what is a "failed bank" in this context. This concept should be clarified as a matter of urgency. For the purposes of this response, we have

assumed that a "failed bank" would be one to which measures under the Banking Act 2009 had been applied or which went into other resolution or insolvency processes, as indicated in the discussion of a possible criminal offence at para 4.5 of the consultation. This could include banks that are (or were) recapitalized without going into any form of administration and banks from which a bridge bank was spun out, as well as banks substantial parts of which were immediately transferred to a third party (eg Northern Rock branches and deposits transferred to Santander).

The ability to determine what a "failed bank" is, and the precise point at which such failure occurred, will be critical for the successful operation of the proposals in the consultation.

2. Scope of application of the proposals

While it appears to be envisaged that the criminal sanctions regime (set out in section 4 of the consultation) could be made to apply to senior managers of a bank who are not statutory directors, the consultation (at least as currently phrased) proposes to introduce the rebuttable presumption (set out in para 3.11 of the consultation) only in relation to the directors of a bank. That said, the consultation expressly states (in para 1.5) that the aim of that measure is that of ensuring that directors and senior management take full account of the risks involved for their institutions when making decisions.

It is also unclear whether the term "director", in the context of the consultation, includes shadow directors and corporate directors and, if so, how the proposals will operate in practice in relation to those directors.

We can envisage a justifiable policy basis for concluding that certain senior divisional managers in a bank may have sufficient authority to make strategic decisions which are capable of having a material impact on the financial position and, ultimately, viability of a bank. Similarly, it seems reasonable that shadow directors and corporate directors should also be subject to the proposals.

It will, however, be critical for the banks and individuals concerned to know whether they fall within the scope of the proposals or not.

Responses to consultation questions

1. What are your views on the proposal to introduce a rebuttable presumption along the lines set out in paragraph 3.11 that the directors of a failed bank are not suitable to hold senior executive positions in other financial institutions?

While the idea appears at first to have some merit, we believe that there are a number of real practical issues and issues of proportionality and fairness which would need to be addressed in order to make the proposal workable. The extent of these would be such that it is questionable whether the proposal would achieve more than can be achieved under existing legislation. In particular, it is already the case that the FSA, faced with an application from an individual wishing to take up a position as a senior executive of a financial business, can withhold approval on the basis of the individual's previous career history, including having had a senior role in a failed or badly run financial business.

Practical issues:

1.1. Wherever any part of the business of a "failed bank" is subsequently to be carried on, whether in a whole bank resolution, in a bridge bank, in a transferee bank or to effect an orderly liquidation, at least some members of existing senior management would be likely to be needed in the business to ensure continuity. If those senior managers/directors were subject to the presumption, it would be very difficult for them to be kept in place (even if the presumption would, in theory, only affect their next job (see para 3.11 of the consultation)) and it would be impossible for the FSA to approve any of them for a role in a different bank (including a bridge bank) without due process which would inevitably take some time. This could result in a management gap at a crucial time. The same considerations would apply if there were a hive down to a new subsidiary within a special administration regime, so as to facilitate the sale of a viable part of the business.

1.2. The proposal in its current form does not restrict the application of the rebuttable presumption to individuals who were directors of banks at the time of the bank's failure. Potentially, therefore, the presumption could apply to any individual who has served as a director (or other influential senior manager) of a bank that has subsequently failed, notwithstanding that he/she may have left the bank prior to the failure; conceivably it could also apply to an individual who joined the bank's board after the commencement of the bank's failure, albeit subject to the ability to rebut as regards personal culpability and responsibility. As a result, the presumption may apply to a number of directors/senior managers who had in no way contributed to the failure of the bank and may well have done all they could to prevent it. They would all have a slur on their reputation which could be cleared only by being approved for a new senior role in the financial sector. Some former directors might be forced to resign from their current posts so as to avoid any taint on their new employer when they are in no way implicated in the failure.

1.3. The presumption could discourage good candidates from applying for senior roles at banks, particularly at times when new management was needed following a loss (not thought to threaten solvency, but with its scope unresolved), a substantial ratings downgrade, when a bank was continuing with new management after recapitalization or where a bridge bank was being established but the viability of the transferred business had not yet been rigorously audited. All of these situations are ones in which the best management is needed. Those prepared to take the positions might seek higher pay, fearing that if they found a more serious situation or, despite their best efforts, could not turn the business round, they could suffer potentially unjustified damage to their reputation and employment prospects. The recruitment difficulty would not help to manage the bank through a crisis that might be capable of causing serious damage to the UK economy.

1.4. The presumption could have longer term adverse effects on the recruitment of good candidates to the banking sector, as similar risks would not arise in other business sectors. It is also a disincentive to the establishment of new banks incorporated in the UK, which is at odds with the desire to promote greater competition in the UK banking sector.

1.5. It is unclear whether the presumption would apply at holding company board level, at authorised bank level or across the whole group including one or more authorised banks. The level at which the presumption applies would make an important difference to the number of the directors affected and the extent to which holders of non-executive posts could be affected. Clarity on this would be important.

Proportionality issues

1.6. It would be most proportionate if the presumption applied only to directors or senior managers of the failed authorised bank and not to any other persons, such as directors of a holding or sister company or subsidiary of the authorised bank (unless, for example, the directors of the authorised bank are accustomed to act in accordance with the directions or instructions of the holding company or one or more of its directors). However, the proposed division of banking activities between retail and other means that UK banking groups will increasingly adopt structures in which the authorised bank is a subsidiary and senior group management will not necessarily be on the board of that authorised bank. Notwithstanding that the aim of the proposed division of banking activities is to safeguard retail banks within larger groups, a failure of the whole group might nevertheless arise from a failure on either the retail or the wholesale side (and, in the case of conglomerates, from a failure of a non-bank business). It may be unfair and unnecessary, for example, to apply the presumption to a director of a retail bank within a failed banking group, if the failure was occasioned by activities of a rogue trader on the investment side; there are difficult questions about where to draw the line so as to be fair.

1.7. As we have noted, as a practical matter, the presumption could limit access to good managers for a bank in difficulty (even if it is not certain that the bank will fail) and for bridge banks. It may also affect the management resources available to administrators seeking to realise value from the business and to purchasers of substantial parts of a failed bank. If the presumption is introduced, there should be a mechanism by which the presumption could be disapplied in advance in relation to directors or senior managers brought in to assist a bank in difficulty prior to failure or to assist with management of the bank's business post-failure.

1.8. There is a question whether it can ever be fair or reasonable to raise such a presumption without providing a means to rebut that presumption except in the context of another job application in the same sector. The presumption would be likely in practice to create a bar to appointment as a director or senior manager of a company in another sector and would be likely to create difficulties in obtaining other employment both in the public and the private sector. We consider that an ability to rebut the presumption by, for example, obtaining a declaration of fitness, would be important to prevent unreasonable interference in the right of affected individuals to earn a living.

The FSA's powers under existing legislation

1.9. Under the approved persons regime in the UK, the FSA must approve each of the senior executives of a bank and, in its disciplinary toolkit, has powers to revoke or suspend any such individual's approval. The FSA can also make a

prohibition order, preventing an individual from performing any functions in the financial services sector. Under the current regulatory regime, the burden is on the FSA to prove that an individual is not suitable to hold an executive position in a bank when seeking to revoke an approval or make a prohibition order.

1.10. In the case of new applications for approval, the FSA is entitled to take into account a range of factors when assessing an individual's suitability for a senior management role, including his or her involvement with previously failed firms. In this context, the FSA does not need to prove that an individual is not fit and proper for the role in order to turn down an application for approval, although any such decision is reviewable before the Upper Tribunal. If it is nevertheless thought desirable to reiterate that weight may be given to responsibilities in former positions in the sector, that could be done, but as acknowledged in the consultation, this should not distort the "fit and proper" test, by giving undue weight to the mere fact of failure, and should instead focus on the extent to which the person's role raises fundamental questions about their competence or general suitability to perform a similar role again.

1.11. We consider that the existing powers of the FSA, described above, already cover the situation fairly and adequately, and correctly place the burden of proof on the FSA.

2. What are your views on the possible supporting measures discussed in this chapter aimed at clarifying management responsibilities and changing the regulatory duties of bank directors?

We would favour the clarification of management responsibilities proposed at para 3.17 and have a preference for the firm-led approach. We consider, however, that such written statements of management responsibilities will be difficult to implement and monitor in practice.

We also favour the suggestions for regulatory duties proposed at para 3.22, namely requiring banks explicitly to run their affairs in a prudent manner, and requiring bank boards to notify the FSA where they become aware that there is a significant risk of the bank being unable to meet the threshold conditions for authorization.

We note, however, that the FSA already has power to sanction individuals for breach of the FSA's Statements of Principle and Code of Practice for Approved Persons (APER) and can impose unlimited fines. It is not clear how the proposals in para 3.22 of the consultation would differ in substance from the duties that already apply to approved persons – and, in particular, SIFs - under APER:

- Statement of Principle 2 requires approved persons to act with due skill, care and diligence in carrying out their controlled functions;
- Statement of Principle 4 requires approved persons to disclose appropriately any information of which the FSA would reasonably expect notice;
- Statement of Principle 6 requires approved persons performing significant influence functions to exercise due skill, care and diligence in managing the business of the firm for which they are responsible in their controlled functions; and

- Statement of Principle 7 requires approved persons performing significant influence functions to take reasonable steps to ensure that the business of the firm for which they are responsible in their controlled functions complies with the relevant requirements and standards of the regulatory system.

It is possible that the concept of "prudence", as used in the consultation, is intended to carry a rather different connotation than that of "care", as used in APER, perhaps with an emphasis on taking "full account of the downside risks" (para 1.5) or placing "greater weight on avoiding downside risks" (para 2.7). If so, it will be important for boards to have clarity on the FSA's expectations by way of formal guidance.

We consider, however, that any clarification of management responsibilities or regulatory duties should be designed to assist forward-looking management of banks, and not merely to assist backward-looking allocation of responsibility in the event of the failure of a bank. In particular, it should be acknowledged that no bank can be operated without incurring some downside risk, and that circumstances may conspire against decisions made by managers acting with all due skill, care and integrity.

3. What are your views on extending criminal sanctions to cover managerial misconduct by bank directors?

We strongly disagree with this proposal. The current situation, whereby the criminal law applies in the financial sector only to offences of fraud or dishonesty, and to certain other offences such as insider dealing, should not lightly be overturned.

We welcome the view expressed in the consultation paper that a strict liability offence would be inappropriate and agree with the reasons given. Such an offence could lead to unjust results, since directors and senior managers who were not responsible for misconduct in the management of a bank and may have done their best to prevent it, would nevertheless acquire a criminal record in the financial sector which would inevitably have a severe impact on their careers.

We note that regulatory sanctions for negligence, incompetence or recklessness in management of a bank already exist and that certain directors of both Northern Rock and HBOS were fined under these provisions. The former Chief Executive of the corporate division of HBOS was fined £500,000 for failure to exercise due skill, care and diligence in managing the business for which he was responsible and the former managing credit director at Northern Rock was fined £140,000 for failing to ensure that the management information reported by the unit for which he was responsible was accurate despite warning signs at an early stage. Both were banned from performing any significant influence function at an FSA-regulated firm. It should also be remembered that following an FSA investigation, the former Executive Director of RBS and former Chairman of Global Markets settled with the FSA on the basis of undertakings not to perform any significant influence function or undertake any further full time employment in the financial services industry.

The fact that the FSA did not fine any RBS director is not a ground for believing that criminal offences are needed. With the higher burden of proof in criminal cases, and the practical difficulties set out in paras 4.15 to 4.17 of the consultation, it does not seem likely that the existence of a parallel criminal regime would have made a significant difference to the sanctions imposed on individuals following the recent set of bank

failures.

The consultation notes that it is usually more difficult to mount a criminal prosecution, and that the process is onerous, but does not mention that the existence of a criminal investigation:

- may prevent or delay imposition of civil penalties (and may make it more difficult to impose civil penalties if the prosecution fails);
- may mean documentation is not available for civil processes (particularly where the prosecuting authority and the civil investigator are different); and
- is likely, while pending, to limit public discussion and to prevent the publication of official reports on matters of great public interest.

Given the difficulties involved in imposing criminal penalties, and that experience has demonstrated that civil penalties can be both severe and highly effective, there seems to be little advantage in implementing a criminal regime as proposed in the consultation.

We note that in the USA directors of banking organisations, including failed banking organisations, are subject to severe civil sanctions. The severity of those sanctions depends on a number of factors, including the state of mind of the director and the nature and consequences of the director's conduct.. The maximum penalty for regulatory violations may range up to US $1.375 million per day (as increased for inflation) for the duration of the violation (see 12 U.S.C. 1818 (i)(2)).

In addition, the Federal Deposit Insurance Corporation ("FDIC"), as receiver of a failed U.S. bank, routinely reviews the conduct of bank directors following a bank failure to determine whether they properly discharged their fiduciary duties, and seeks civil damages in cases in which the applicable standards were not met. In this capacity the FDIC will generally pursue civil claims against bank executive directors on a negligence standard and will pursue civil claims against non-executive directors on a "gross negligence" standard. They will also pursue directors on a civil basis for "breach of loyalty", recklessness or fraud.[1] Criminal sanctions, however have been reserved to address specific wrongdoing covered by specific provisions of the criminal laws, and have usually been based on fraud or dishonesty.

We also note that the Liikanen Report commissioned by the EU (Report of the High-level Expert Group on reforming the structure of the EU banking sector published on 2nd October 2012) considered the subject of director sanctioning. It did not recommend the introduction of criminal offences, but at paragraph 5.5.5 stated "In order to ensure effective enforcement, supervisors must have effective sanctioning powers to enforce risk management responsibilities, including sanctions against the executives concerned, such as lifetime professional ban and claw-back on deferred compensation." The FSA already has the power to impose bans against working in the industry again when

[1] English law would not recognise different standards of negligence, though no doubt what amounted to negligence would reflect the differing roles of executive and non-executive directors. Companies, including companies in insolvency processes can bring civil proceedings against directors and managers for negligence or fraud, the proceeds of which benefit creditors (in the case of a failed UK bank the largest of these would be likely to be FSCS standing in the shoes of insured depositors). Shareholders have rights of action on similar grounds.

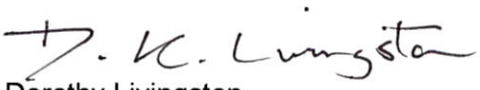
justified and a number of initiatives in relation to pay claw-back are underway. We do not believe that a criminal regime would add to effective enforcement.

4. What are your views on the possible formulations of a criminal offence discussed in this chapter?

We do not consider that any of strict liability, incompetence, negligence or recklessness are suitable standards for the foundation of a criminal offence in the financial sector, nor do we consider that a criminal regime is necessary or feasible in practice. Civil sanctions are both appropriate and sufficient.

We should be happy to discuss these views further. Please contact the Chairman of the Financial Law Committee, Dorothy Livingston, at Herbert Smith Freehills LLP (dorothy.livingston@hsf.com) if you would like to do this.

Yours faithfully



Dorothy Livingston
Chair, Financial Law Committee

(The names of the members of the CLLS Financial Law Committee are available on the CLLS website.)