

Sanctions for Bank Directors

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Summary

The key points of our response are the following:

- Whilst we agree that the imposition of criminal liability for directors of financial institutions would have an important signalling effect, we doubt whether it would have much impact on behaviour in practice over the long term for reasons which we specify.
- If criminal liability were to be introduced, we think that the standard should be one of reckless or wilful breach and that it should apply to both directors and non-executive directors.
- The introduction of a rebuttable presumption would not materially alter the current regulatory position.
- The apparent reluctance of the FSA to take enforcement action against either firms or individuals for conduct related to the financial crisis is likely to be due to factors other than lack of enforcement powers or inadequately specified regulatory rules.
- The scope of APER should only be extended on a case by case basis, but that some clarifications could be beneficial; however we support the proposal that those exercising significant influence functions should be subject to APER in the conduct of all their regulatory activities.
- There should be greater dissemination of the standards of behaviour expected, for example by respected bodies such as the Institute of Directors, but that the introduction of a separate transnational, but mandatory, professional body is unlikely to be feasible or bring practical benefits.
- The Commission should consider whether the burden of proof should be reversed in demonstrating compliance with APER, in an analogy to the situation under health and safety legislation (where it is for the firm and individual directors to demonstrate that there is a safe system of work).
- The Commission should consider three further sets of reforms
 - Reforms to the duties of directors of ring fenced banks or those enjoying a ‘too big to fail’ subsidy to require them to owe their duties to all their constituents, not just to shareholders, or alternatively to specify a hierarchy of interests - that they owe their duties primarily to deposit-holders, and secondarily to shareholders;
 - To bar directors of ring fenced banks or those enjoying a ‘too big to fail’ subsidy to from being paid bonuses, or for the bonus policy to be akin to that in the public sector;
 - The promotion of an ethical culture across the financial services industry through the development of targeted supervisory strategies, notably encouraging regulators to extend the FSA’s ‘treating customers fairly’ approach to ethics and developing strategies of ‘ethical scenario analysis’ and ‘ethical stress testing’ throughout the firm in conjunction with senior management.

¹ The authors are Professors of Law at the London School of Economics and Political Science, and are writing in their personal capacity. Note that the original text and questions posed by the Commission are in bold font throughout.

Responses to the Questionnaire

The Parliamentary Commission on Banking Standards was established to consider and report on professional standards and culture of the UK banking sector. One element of the Commission's work is to consider the sanctions (criminal, civil and regulatory) that can be imposed on directors and make recommendations for any legislative or regulatory changes that may be required.

In order to aid evidence gathering, the Commission would welcome responses to the following questions by 11 January 2013.

Criminal Sanctions

On 3 July 2013, HM Treasury published a proposal to create a new criminal offence of serious misconduct in the management of a bank. The proposal considered four main possibilities for the kind of managerial misconduct by bank directors and senior management that might be subject to new criminal sanctions:

- (i) Strict liability – being a director at the relevant time of a failed bank**
- (ii) Negligence – failure in a duty of care which leads to a reasonably foreseeable outcome**
- (iii) Incompetence – failure to act in accordance with professional standards or practices**
- (iv) Recklessness – failure to have sufficient regard for the dangers posed to the safety and soundness of the firm concerned or for the possibility that there were such dangers.**

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

1.1 Some commentators (e.g. P. Ramsay, 'The Responsible Subject As Citizen: Criminal Law, Democracy And The Welfare State' (2006) 69(1) Modern Law Review 29) argue that one of the primary reasons why we criminalise certain activity is because the state has a broader interest in deterring that activity which is distinct from providing justice or recompense to the persons who are directly injured. In this regard a case can be made that there is a role for the criminal law in regulating bank activity as when banks fail the costs imposed on society are enormous. The State's interest in having a banking system that effectively intermediates savings and provides a payments system provides such a distinctive "state interest". Note however, that the extent of such a "state interest" varies with the nature of the financial institution: the more systemically important the financial institution the more apposite this justification.

1.2 A criminal offence for managerial failings would also amount to a strong signal of society's disapproval of bank conduct that led us into the financial crisis. It would also, in the opinion of many citizens, address the view (whether or not this view is correct) that the scope of criminal law is in some sense unjust because it criminalises smaller scale misconduct but does not hold powerful businessmen responsible for the economic destruction wrought by the financial crisis.

1.3 The above considerations provide good reasons for introducing such a criminal offence but in our view one should not expect such an offence to have a notable impact on bank conduct and culture

over the longer term. That does not, for the reasons given above, mean that such an offence should not be introduced, but it does mean that it should not be mistaken for an effective remedy for recent examples of bank misconduct and bank cultures that have fostered such behaviour. Although there are multiple corporate criminal offences that apply to companies more generally they are very rarely enforced. In our view more effective remedies are to be found in altering the still skewed incentive structure to which directors and senior managers are subject (generated by corporate law, not merely by methods of remuneration). We discuss this more fully in our answer to question 28 below.

1.4 Although some commentators argue that an effective enforcement deterrent (including using criminal law and significant periods of incarceration) is central to disciplining and improving bank behaviour there are several theoretical and practical reasons to doubt that this is the case. In this regard we make the following observations.

1.4.1 The extent to which any liability rule deters the targeted activity depends on:

- (i) the probability of being caught;
- (ii) the probability that an action will be brought if caught;
- (iii) the probability of being found liable in any suit or prosecution given the nature of the offence and the applicable burden of proof; and
- (iv) the consequences of being found liable.

1.4.2 Although this leads us into the territory of the next question, the standard that is adopted will have very significant effects on the probability that misconduct will be sanctioned and the effectiveness of a criminal offence as a deterrent.

1.4.3 *Strict liability standard* If a strict liability standard is adopted the deterrent effect is likely to be significant. But a strict liability standard for an individual director or senior manager that results in the significant criminal fines or incarceration would be draconian, and are unlikely to be imposed. In other areas of regulation where there are strict liability offences, for example in health and safety or environmental regulation, the result has been that the sanctions imposed have often been negligible. This weakens the deterrent effect and diminishing the stigma attached to the criminal liability standard. Indeed, the practice of imposing low fines for breaches of regulatory offences was criticised in the Hampton Review (*Reducing Administrative Burdens; Effective Inspection and Enforcement* 2005), and led to the BRE / Macrory Review of regulatory sanctions (*Regulatory Justice: Making Sanctions Effective*, 2006), and in turn to the Regulatory Enforcement and Sanctions Act 2008, which expanded civil sanctions to compensate for the effective failure of criminal sanctions.

1.4.4 *Negligence standard* We also think it inappropriate to adopt a negligence standard for a criminal offence (note that the negligence and incompetence standard in the above list are, from a legal standpoint, aspects of the negligence standard). While negligence standards for corporate individual crimes are clearly not unheard of they are problematic for a number of reasons.

- (i) First, criminal offences are typically associated with very serious failings – ideas of recklessness or gross negligence resonate with such failings. Many might ask whether mere negligence is sufficiently culpable to warrant criminalisation. In a major study on the role of criminal law in regulatory regimes, the Law Commission recommended that criminal liability should only be imposed where there was a ‘harm related moral failure’ and not simply to act as a deterrent. Individuals should not be subject to

criminal liability unless their wrongdoing was knowing or reckless (*Criminal Liability in Regulatory Contexts*, CP 195, 2010, chapter 4 and para 8.11).

- (ii) Second – which goes to question 3 below – adopting a negligence standard could have a chilling effect. As bank failings are judged with hindsight, many managers would fear that their competent and reasonable risk taking activity may, with the benefit of the knowledge of failure, be judged more harshly after the fact. If that is the case it could result in extreme risk aversion by managers and directors, or their refusal to serve. In systemically important banks such aversion may be a good thing, however it would not be beneficial across the financial sector as a whole. More importantly, it is reasonable to think that such a standard enforced by the FCA would lead many managers to refuse to serve. Importantly, it will be the more risk-averse managers and directors who are more likely to refuse to serve which means that such a standard could paradoxically lead to only those who are risk-takers self-selecting to become members of bank boards, and thus have a negative effect on bank conduct from society's perspective.
- (iii) Third, not all of the activities that created the financial crisis would contravene a negligence standard, indeed many may not. The reason for this is that a negligence standard judges a manager's behaviour by the benchmark of the hypothetical reasonable average bank manager's behaviour. If the managers' peers are behaving in the same way, then although as a group of citizens we may view this behaviour as negligent, the court may not agree when applying the standard to the individual.
- (iv) Fourth, there is little reason to think that enforcement will be any higher if the standard is lower. Consider, for example, the criminal offence associated with financial assistance in section 156(7) Companies Act 1985 for which there is no reported criminal prosecution. It seems likely that one of the reasons for this is the difficulty of obtaining a conviction even though on the face of the statute the standard is a negligence standard. Of course, resource constraints of the prosecution authorities may be a relevant consideration as well (discussed below).

1.4.5 *Recklessness standard* Accordingly, if a criminal offence were to be introduced the preferable standard would be akin to one of recklessness (although one that is articulated differently to that above, which sounds rather similar to a negligence standard). In the US, for example, (Delaware Corporate Law) the civil care standard for directors is a gross negligence standard that deploys the idea of recklessness: "reckless indifference to or deliberate disregard to the whole body of shareholders". The problem with a recklessness standard is that it is very difficult to prove, especially with a criminal burden of proof. This is particularly the case where risk management systems are in place and where the risk strategy adopted by the bank is a rational one for the bank and its shareholders (if not for society). Furthermore, even where the activity in question is clearly unlawful – such as with LIBOR rigging - managers can communicate preferences which result in misconduct without referring to or directing subordinate employees to engage in such misconduct. In such instances the possibility that managers will be found to fall foul of a recklessness standard are very low.

1.4.6 *US experience* Certain US commentators argue that there significant advantages in deterring wrongdoing by a strong public civil and criminal enforcement policy. In this regard it is clear that: (i)

US authorities have long been more aggressive and have devoted more resources to their enforcement policy than UK authorities; (ii) US authorities aggressively deploy procedural means such as plea bargaining to obtain enforcement without trial which have either not been available or more difficult to deploy in the UK; and (iii) US criminal sanctions have been much more onerous than comparable UK sanctions – Jeffrey Skilling was sentenced to 24 years, Kenneth Lay 45 years, Bernie Madoff to 150 years. It is correct that by providing more resources to enforcement, by being more willing to deploy such enforcement tools, and by increasing the costs of being sanctioned (financially and long term loss of liberty) that the deterrent effect of a criminal offence is increased.

1.4.7 However, it is also clear that even with such an enforcement outlook and sanctions the deterrent effect may remain weak when one factors in the probability of being caught and successfully prosecuted. One only has to consider many of the actions brought to light by the financial crisis and the Madoff scandal - which all occurred within the salient presence of the Enron, WorldCom and Martha Stewart criminal sentences - to see this. One view of the deterrent effect of criminal sanctions is that although the probability of being caught and sanctioned may in fact be very low that when a high profile person is successfully prosecuted this results in other market players overweighing the actual possibility that they too could be prosecuted. That is we have an irrational response to the fear of ending up like Jeffrey Skilling and therefore we are deterred. Empirically it is very difficult to assess whether there was such an effect on US managers post-Enron and WorldCom. We know only that in multiple instances this was not the case.

1.4.8 *Costs* In the UK the costs of enforcement actions are very high. One only has to look at the list of lawyers in the Pottage v FSA (which exonerated MR Pottage in relation to a £100,000 fine) to realise that the legal costs far exceeded the value of the fine in that case and that, more generally, market participants have very strong incentives to deploy their deep pockets to resist enforcement action. For a regulator to compete effectively with such deep pockets and to increase the probability of successful suit would require very significant increase in resource. Note also, as the Madoff scandal highlights even comparatively resource rich US regulators are subject to clear resource constraints that put them at a significant disadvantage in identifying and understanding financial crime.

1.4.9 In summary, given (i) that a significant increase in enforcement resources is improbable, (ii) even if it occurred its effectiveness is limited, and (iii) that the harsh US-type sanctions are not likely to be deployed in the UK, we see that the behavioural effect of a criminal offence based on a recklessness-type standard will be modest at best.

2. What are your views on the possible formulations of a criminal offence based on options (i) to (iv)?

2.1 See 1.4.3-1.4.5 above.

3. Do you think that an offence based on one of those options would be likely to discourage those considering positions of leadership within banks?

3.1 It depends on the selected standard (see 1.4.3-1.4.5 above). If a negligence standard was selected then yes, it could discourage risk-averse individuals from considering leadership positions in banks, with paradoxical effects as noted above. A more onerous standard – such as a recklessness standard – could have a more limited effect in this regard. These effects could be muted if the offences were

combined with a due diligence defence, as recommended by the Law Commission for offences relating to managerial conduct which do not involve fault on the part of the wrongdoer (*Criminal Liability in Regulatory Contexts*, para 8.14).

4. Will the possibility of criminalising behaviour which can already be sanctioned under Financial Services and Markets Act 2000 (FSMA) act as a greater deterrent?

4.1 As criminalising behaviour may result in harsher sentences – both fines and incarceration – and as a criminal record carries with it significant and distinct social stigma, then the effect of criminalisation could increase the deterrent effect of an identical civil or regulatory sanction, but only if prosecution is likely to be successful and the sanctions are not negligible in practice, as noted above in the response to question 1.

5. Do you think that it is likely that the threat of criminal action will stifle perfectly legitimate activity and ultimately deter growth in the banking sector?

5.1 See the response to question 3.

6. What are your views on the statement that there appears to be significant reluctance from regulators to take criminal prosecution against banks or individuals responsible for compliance functions? To the extent you agree with the statement, what, in your opinion, are the reasons for this reluctance?

6.1 We agree that this assessment is correct. Many of the reasons are discussed more fully in the answer to question 1. The reasons include:

- (i) significant asymmetries of skill and knowledge in understanding whether financial activity has broken the applicable rules;
- (ii) resource constraints and a pragmatic recognition that using resources on enforcement, although may generate media profile, may have a limited behavioural impact;
- (iii) the more demanding behavioural standards and the criminal burden of proof;
- (iv) a recognition that whatever the behavioural standard courts are unlikely to make a finding of criminal wrongdoing unless there is clear evidence of serious misconduct;
- (v) limited and more problematic availability of procedural negotiating tools such as plea bargaining;
- (vi) possibly, a view that financial crime is not as morally culpable as other types of crime;
- (vii) a longstanding fear – which is being partially corrected – that aggressive regulatory action will damage the attractiveness of the UK's financial industry; and, relatedly
- (viii) a political climate which was perceived as unsupportive of tough regulation of international financial institutions or their senior managers.

Civil and Regulatory Sanctions

Rebuttable Presumption

On 3 July 2012, HM Treasury published proposals to amend FSMA in order to put in place a rebuttable presumption that a director of a failed bank is not suitable to be approved by the regulator as someone who could hold a position as a senior executive in a bank. The Government also proposed two groups of ‘supporting measures’, which could be taken forward by the regulators under existing FSMA powers:

- (a) Introducing clearer regulatory requirements on individual responsibilities and the standards required of people performing certain key roles; or, in the alternative, a ‘firm-led approach’ (with the onus on the firm and individual to set out a detailed written statement of the responsibilities and duties of each role); and**
- (b) Requiring banks explicitly to run their affairs in a prudent manner, and requiring bank boards to notify the regulator where they become aware that there is a significant risk of the bank being unable to meet the threshold conditions for authorisation.**

7. What are your views on the proposal to introduce a rebuttable presumption that the directors of failed banks are not suitable to hold senior executive positions in other financial institutions?

7.1 It is a reasonable proposal that would not exclude such an executive working again in the industry if s/he could demonstrate that s/he was not culpable. However, as with the possible criminal offence discussed above one should not overstate the likely disciplinary effect of such a presumption. As the crisis has demonstrated, the leaders of failed banks will suffer significant reputational damage which means that even in the absence of a regulatory ban it is highly unlikely that they could ever work at any level in a bank again, and indeed for some to find work in any industry. From the perspective of the bank manager (prior to failure) the projected financial costs of failure for her/him personally are likely to be close to the same with or without such a rebuttable presumption. Accordingly, the behavioural impact of the presumption is neutral.

8. Does the rebuttable presumption go any further than the current regulatory regime?

8.1 It is formally different but substantively neutral given the current powers set forth in the Financial Services Act 2010.

9. Do you think that the introduction of the ‘rebuttable presumption’ could discourage skilled individuals from accepting key management positions?

9.1 For the reasons set forth the answer to question 7 above we think the effect in this regard would be neutral. However, any introduction of a rebuttable presumption could be accompanied by a requirement for the regulators to review its operation after a period of time, such as 5 years.

10. Do you think introducing the presumption would send a clear message that bank senior executives and boards have a responsibility to ensure there is a strong focus on downside risks?

10.1 No more than currently exists.

11. What are your views on the possible supporting measures aimed at clarifying management responsibilities and changing the regulatory duties of bank directors?

11.1 This is currently possible under the existing arrangements for SYSC and APER and so arguably does not require new legislation. Moreover the FSA has indicated that both the FCA and PRA will be elaborating further on the responsibilities that approved persons holding significant influence functions will have in their respective rulebooks (CP 12/26). There is no clear need for further specification of these responsibilities in legislation, indeed given the significant disparities in size and management structures of firms regulated by each of the FCA and PRA, such specification is not recommended. However the Commission could encourage the regulators to specify these responsibilities further, and we address the question of whether APER should be amended or clarified in question 17 below.

11.2 The Commission could also encourage the regulators to engage with others bodies to help clarify and communicate their personal regulatory obligations more clearly and directly to senior managers. The practice of the UK Corporate Governance Code (eg., the Financial Reporting Council's *Guidance on Board Effectiveness*) shows how useful it can be to provide directors with clear guidance as to what exactly they are expected to do. Anecdotal evidence suggests that boards have largely welcomed this guidance. Such supporting measures may operate as a personal benchmark for directors and senior managers when performing the role as well as a benchmark for the periodic assessment of overall bank board effectiveness. Similarly, in the area of health and safety, where directors can be held criminally liable for breaches of health and safety legislation by their companies, the Health and Safety Executive has worked with the Institute of Directors to produce a clear set of guidance to directors and senior officers as to their responsibilities (IOD and HSE, *Leading Health and Safety at Work*, 2007).

11.3 The supporting measures which go beyond simply elaborating more rules should, therefore, be strongly supported. A hybrid approach would be best whereby the general guidance is set forth by the regulator, potentially in conjunction with leading representative organisations, but it is expected that the financial institution will engage directly with these supporting measures and tailor them to the nature of the financial institution's business.

11.4 In addition imposing obligations on directors and senior managers to have to run the company in a prudent manner is something that should be considered. This could be addressed through APER (see below, para 17.6), and / or through the corporate objective applicable to banks according to UK corporate law. We address this point further in our answer to question 28.

Existing Regulatory Sanctions

The Financial Services Act 2010 provided the FSA with greater enforcement powers. The FSA has the power to fine authorised persons and approved individuals for misconduct. The 2010 Act extended these powers to enable the FSA to suspend or limit an authorised person's permission or an approved person's approval. It also enabled the FSA to impose a fine on an individual performing a controlled function without approval in addition to being able to prohibit the individual from working in the financial services industry. It also included provisions in respect of the disclosure by the FSA of decision notices.

12. Despite the range of enforcement powers currently available to the FSA, are additional powers necessary? If so, what would those powers be?

12.1 As the Commission notes, the FSA already has powers to impose a range of sanctions on individuals, including public censure, imposition of financial penalties and prohibiting that person from acting as an approved person in the future, or for a period of time. It is not clear that any additional sanctions would act as a significant deterrent to misconduct or otherwise encourage compliance. Other strategies have to be found. We address this more fully in question 28 below.

13. What are your views on amending FSMA to include a power to prohibit an individual from performing a controlled function on an interim basis?

13.1 The FSA has suggested that the FCA should also be able to suspend a person from acting as an approved person whilst it conducts investigation into approved persons. Whilst this would no doubt be useful to the regulators, and give them a more complete set of powers, it is difficult to see that it would transform their ability to bring enforcement actions against individuals.

14. Considering the current powers and measures, do you think the perceived shortcomings in being able to hold individual directors personally culpable are as a result of statutory or regulatory deficits or as a result of regulators and law enforcement agencies not utilising the powers already available to them as fully as they could?

14.1 The FSA has brought cases against individuals for breach of APER provisions in the past, but it is clear that enforcement under APER has not proved to be a robust regulatory tool in the wake of the crisis. Just why so few enforcement actions against individuals for crisis-related failings have been brought is a question to which only the FSA can provide the answer. However a number of factors could be at play, many of which echo the arguments expressed in response to question 1 above.

14.2 First, the current provisions do provide considerable scope for regulators to take enforcement action for breach of APER, but each case is always going to turn on its facts. The selection of cases for enforcement brought by both the FSA and that of the Australian securities regulator, ASIC, suggests that certain types of breaches are easier to prove than others. Notably, misconduct which involves misleading statements, for example, is easier to demonstrate than misconduct which involves failures of oversight. In cases involving failures of the overall management system, and in a context of collective decision making, pinpointing individual culpability can be difficult, though not impossible, as the Cummings case illustrates. However, it is clear from the Pottage case that it is difficult to prove that there has been personal culpability for failure to supervise effectively where the individual is responsible for the oversight of complex operations being performed by numerous individuals often operating in a number of divisions, in a matrix management structure in which the functional requirements of managers based overseas can conflict with the regulatory requirements to which local operations are subject.

14.3 Second, taking enforcement action is a risk. Any decision to take enforcement action has to involve an estimation of likely chances of success. As with any decision involving risk (and cost), decision makers can be risk-preferring or risk-avoiding. The benefits for the regulator of bringing a successful action have to be weighed against both the financial cost and reputational damage of bringing an action, but losing.

14.4 Third, taking enforcement action is costly. Again, it would be for the FSA to confirm the costs of an investigation such as that which led to the actions against Pottage or Cummings, but the costs both of investigation and of taking proceedings can be substantial. For example, as noted above, in

the Pottage case, the FSA sought to impose a fine of £100,000 on the individual concerned. The level of the fine was dwarfed by the legal costs involved: in the Upper Tribunal the parties (including UBS) were represented by at total of two QCs, three counsel and two solicitors from leading City firms. Though the parties' costs were not disclosed, they are likely to have exceeded the level of the fine sought by a considerable margin.

14.5 Fourth, given the risks and costs involved, there is a real question of how should resources be best allocated, and what the opportunity costs are in taking one enforcement action rather than another. During the period when it would have been pursuing those actions against individuals under APER the FSA has been bringing a number of other criminal prosecutions against individuals for insider dealing which have been successful. It has also been pursuing a significant number of PPI misselling cases against firms. It is impossible to say without knowing further details whether the FSA would have had sufficient financial and personnel resources to pursue these actions as well as pursue extensive actions against individuals under APER, and whether if it had brought more actions under APER that these would have been successful. It is also an open question as to why the FSA did not take enforcement actions against more firms for breaches of the Principles for Business, in particular Principles 2 and 3 (due skill and care, and adequate systems of management and controls).

14.6 In the likely event that real choices had to be made as to how to allocate limited enforcement resources, it could be that the FSA decided that risk-benefit calculation pointed more clearly in favour of pursuing cases which has done on the basis that these had a higher chance of success. Whilst the decision may have been rational narrow risk-benefit terms, politically it was probably a miscalculation. The reputational damage for the FSA in not bringing actions against individuals in RBS, for example, or indeed against financial institutions for breach of the Principles, has arguably been far greater than if it had brought enforcement actions which then failed on appeal.

15. What are your views on extending the limitation period for taking action against approved persons?

15.1 Under s.66(4) and (5) of FSMA, as amended by Financial Services Act 2010, the FSA cannot bring an action against an approved person after three years of the date that it 'knew' the misconduct under the approved persons regime occurred. It is deemed to 'know' of the misconduct if it 'has information from which the misconduct may reasonably be inferred'. In contrast, there is no limitation period for bringing actions against firms for breaches of the rules.

15.2 Whilst the limitation period for individuals could be justified on the basis that individuals should be able to have certainty as to their potential exposure to regulatory liability, in other areas of law where liabilities are imposed on individuals, limitation periods are longer, particularly for criminal liability.² In a review of limitation periods conducted in 2001, the Law Commission concluded that the law was unsatisfactory (*Limitation of Actions*, Law Com 270, HC 23, 2001). It recommended the introduction of a 'core limitation period' which would apply to the majority of legal actions (with

² Under the Limitation Act 1980, for example, the limitation period for claims in contract and for simple negligence cases is 6 years. For contracts agreed as a formal deed, it is 12 years. Under the Latent Damage Act 1986, the period is extended with respect to certain negligence claims where the damage is not evident at the time the negligence occurred (other than for personal injury claims), to six years from the date of accrual of the cause of action being raised; and three years from the earliest date on which the potential claimant knew, or reasonably ought to have known, material facts necessary to bring an action alleging negligence, subject to an overall limit of fifteen years from the accrual of damage. In addition, there are a number of other limitation periods relating to other causes of action, including those based on breach of statute.

some adjustments for personal injury cases). This would consist of a primary three year limitation period, starting from the date that the claimant knew or ought reasonably to have known (i) that the cause of action had accrued, (ii) the identity of the relevant individual, and (iii) the scale of the loss or damage, and a long stop limitation period of 10 years, which would run from the action or omission which gave rise to the cause of action, unless the individual had dishonestly concealed the relevant facts. The Law Commission's proposals were confined to actions in private law and have not been adopted, but its reasoning is still cogent.

15.3 There is clearly a balance to be struck between the interests of the individual in not being exposed to an extensive period of potential liability, and the public interest in ensuring that those who are subject to regulatory provisions, which are imposed to further public objectives, can be brought to account if they have breached those provisions. In the regulatory context, given the complexity of management structures and organisational decision making, particularly within large organisations, the delay that there can be in ascertaining that an individual may have been at fault, and the potential social cost that could be associated with compliance failures by individuals, there are good arguments for not curtailing the limitation period unduly.

15.4 However, there is no clear public evidence that the limitation period has operated as a bar to bringing actions. There is also no obvious indication from the FSA that the limitation period has hindered its ability to bring cases against approved persons for suspected misconduct. In particular, in its recent consultation paper on amendments to APER to be introduced by the FCA and PRA, the FSA did not raise the issue (FSA, *Regulatory Reform: the PRA and FCA regimes for Approved Persons*, CP 12/26, 2012). If, however, it has been the case that actions that could otherwise have been brought have been barred because of the provisions on limitation, then either the period could be extended, or the definition of the point at which the limitation period is set to run could be specified more closely in line with the Law Commission's recommendation. For instance, it could specify that the period of three years starts to run from the time at which the relevant regulator (FCA or PRA) had information from which it could reasonably infer (i) that misconduct had occurred, through action or omission, by the relevant individual and (ii) the scale of the misconduct.³

Legislation versus Regulation

16. In order to make bank directors more accountable (due to the adverse impact a large failed bank can have on the wider economy), what are your views on amending the approved persons' regime under FSMA rather than the Companies Act 2006 and the Insolvency Act 1986. To the extent you consider changes should be made to the legal framework, please articulate how you think this could be achieved given the legislation would apply to all company directors.

16.1 It is recommended that any changes should be confined to the regulated sector. Any changes to the general law applicable to companies would run the risk of significant unintended consequences, and a separate inquiry would therefore be needed. Such an inquiry would have to encompass both the legal definition of the relevant duties, and the question of who should be empowered to bring action for their breach. One of the critical differences between the regime for financial regulation and that of company law in general is that there is a public agency responsible for the approval of appointments

³ The requirement (as at present) that the regulator actually has the information addresses the issue of concealment, dishonest or otherwise, for if it the information had been concealed, the regulator would not be in possession of it.

and enforcement of duties of directors and senior managers in financial services firms; there is no parallel public agency responsible for the enforcement of directors' duties in general company law. Australia provides an example of where such an agency exists, the Australian Securities and Investments Commission (ASIC) acts as a regulator of companies and brings civil actions against company directors for failing to comply with their statutory duties of skill and care, for example. Any extension of APER-like provisions to directors and senior managers of companies more generally would have to consider whether a statutory agency such as ASIC would be needed to enforce those duties. Given the scale of the changes this would involve, it is recommended that the current inquiry confine itself to the regulated sector, ie firms which are to be authorised and regulated by FCA and PRA under the forthcoming legislation.

The Approved Persons' Regime (APER)

17. The Upper Tribunal ruling in *John Pottage v The FSA* (FS/2010/0033) highlighted that enforcement action against senior managers is only likely to be successful where there is evidence of actual wrongdoing by the executive concerned. In your opinion, what changes could be made to some of the statements in APER about the standard of conduct expected of directors in order to make it easier to bring enforcement?

17.1 Both SYSC and APER both contain provisions requiring firms to detail the responsibilities of approved persons, particularly those occupying significant influence functions, and APER contains quite extensive guidance as to what the Statements of Principle require. Given the significant variety of firms to which APER applies, it is always going to be difficult to specify the standards of conduct expected with any great precision.

Reforms to the APER regime

17.2 There are nevertheless some enhancements to the APER regime which could be beneficial. Some are already proposed in the Bill; others could be achieved through changes to the APER provisions themselves by the incoming regulators (FCA and PRA).

17.3 First, the Bill provides for an extension of the scope of the APER regime to cover regulated activities performed by a SIF outside the functions for which they are approved. This is a sensible measure which avoids complicated and impractical distinctions having to be made as to what aspects of a person's role fall within or outside their controlled activities.

17.4 Secondly, the guidance relating to the threshold conditions for approval and the APER regime could make it clearer that the fact that a person had been a SIF in a failed financial institution would be a material factor in determining whether or not to grant approval.

17.5 Thirdly, the Statements of Principle require all approved persons to deal with the FSA in an open and cooperative way. The evidential provisions accompanying the Principle require those with responsibility reporting to the FSA to disclose any information which could reasonably be supposed to be of 'material significance' to the regulator (APER 4.4). These could be amended to make it clear that all SIFS, whether reporting to the regulators is within the scope of their controlled function or not, are under an obligation to report if there is a significant risk that the firm is or is likely to soon be unable to meet its threshold conditions.

17.6 Fourth, the Statements of Principle could be amended to include a requirement for prudent management of the firm's business, as well as a requirement to exercise due skill, care and diligence. This would bring them in line with the Principles for Business which apply to firms as a whole (and which it is recommended should be kept by both FCA and PRA, albeit with amendments to reflect their new remits and objectives). Whilst this duty could be inferred from the current Statements of Principle, stating it explicitly would serve to emphasise its importance and raise awareness.

17.7 Fifth, the obligations of SIFs (those occupying significant influence functions) within ring-fenced banks could be separately defined under the PRA (and where relevant, FCA) APER regime. Given that SIFs of ring fenced banks (RFBs) will be a clearly defined sub-set of the regulated population, it should be possible to craft more specific rules or guidance as to what standards of conduct are required from those holding these positions. We develop this point further in the response to question 28.

Changes to the burden of proof

17.8 The burden of proof could be reversed, both in cases relating to breaches of the Principles for Business and for breaches of the APER regime. An important precedent provided by the Health and Safety at Work Act 1974, s.40. This provides

‘In any proceedings for an offence under any of the relevant statutory provisions consisting of a failure to comply with a duty or requirement to do something so far as is practicable or so far as is reasonably practicable, or to use the best practicable means to do something, it shall be for the accused to prove (as the case may be) that it was not practicable or not reasonably practicable to do more than was in fact done to satisfy the duty or requirement, or that there was no better practicable means than was in fact used to satisfy the duty or requirement.’

Under this proposal, it would be for individuals or firms to demonstrate that the actions they took were reasonable, rather than for the regulator to prove that they were not. Such a change would have to be made by legislation.

Consciousness-raising

17.9 The third reform relates not to the specification and definition of senior management responsibilities but to their communication and promotion. We referred above to the HSE's collaboration with the Institute of Directors (IoD) to produce guidance leaflets setting out the responsibilities of senior managers in clear and intelligible language, using practical examples (para 11.2). The engagement of organisations such as the IoD in helping to communicate the nature of senior management obligations and their importance could play an important role in raising awareness.

18. In your opinion, has a lack of direct senior management accountability inside firms for specific areas of conduct contributed to the shortcomings in holding individuals personally culpable? Do you think APER should be revised to remedy this?

18.1 Both SYSC and APER already require firms to document clearly the different responsibilities and remits of each approved person. In particular, SYSC 2.1 already requires firms to

‘take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers in such a way that:

- (1) it is clear who has which of those responsibilities; and
- (2) the business and affairs of the firm can be adequately monitored and controlled by the directors, relevant senior managers and governing body of the firm’.

18.2 SYSC 2.2 requires these arrangements to be documented and for those documents to be kept up to date. In addition, APER 4.5 requires a SIF to ensure that the business of the firm for which he or she is responsible can be controlled effectively. This includes a provision to take reasonable steps to apportion responsibilities effectively. It is difficult to see how the rules could be clearer in this regard.

19. Would it be beneficial for the regulator to adopt a more intrusive approach to senior appointments as part of the Significant Influence Function (SIF) process? How could such an approach be adopted?

19.1 The FSA has adopted a more intrusive approach for the last 2-3 years, when it started interviewing those who were to be appointed to SIF positions, and in a number of cases refusing to accept appointments which the firm wanted to make. Given the importance of effective internal governance in ensuring that the public policy objectives of the legislation are met, such an intrusive approach is justifiable. However, it is a matter for supervisory practice rather than legislation.

20. Do you see merit in requiring the regulator to re-appraise SIF individuals at set intervals and on other occasions if it believes that circumstances justify it.

20.1 Whilst this should be good supervisory practice, it is difficult to see what enshrining this requirement in legislation would add to the current supervisory framework.

21. What are your views on extending APER so that it applies to all bank employees in order to enable the regulator to take disciplinary action against employees who are currently outside the scope of APER?

21.1 The argument in favour of extending APER to all employees, including traders for example, could be that each employee is under a personal obligation to uphold certain regulatory principles and responsibilities. To this extent, it would be akin to the individual obligations held by members of professional bodies, such as lawyers or accountants.

21.2 There is clearly a significant need to raise standards of conduct across the industry, and extending personal liability could at first sight appear to be a potential way to achieve that. However, it is unlikely that the regulator will have the resources to bring actions for breaches by individuals, and indeed the most appropriate actor to impose disciplinary measures should be the firm itself. Further, it is not clear that it would be appropriate for the APER regime to apply indiscriminately to all employees – should it include those working in the office canteen, for example? If the main concern is that APER should be extended so as to catch certain groups of employees, such as traders, then a better approach would be to extend the categories of approved persons on a case by case basis.

22. Do you see merit in the establishment of an independent professional body with mandatory membership which has the power to impose civil and possibly criminal sanctions? In your view,

could such a body provide a solution for the issue of global matrix management structures that can exist within universal banks?

22.1 The argument for creating such a body would presumably be that it would be an attempt to create and infuse a sense of professional responsibility into senior managers, comprising both high standards of competence and a strong sense of ethics.

22.2 Whilst high standards of professionalism are clearly desirable aims to have, it is far from clear how the creation of such a body could achieve them. At the very least, there are a number of practical and legal difficulties which would have to be overcome.

22.3 If such a body were to address the difficulties of extra-territoriality and global matrix management structures, it could not be based in the laws of any one national jurisdiction. It would have to be either based in treaty (which is highly unlikely), or an international organisation akin to the current global regulatory committees, or a self-regulatory body which operates transnationally. In either of the latter two cases it would be operating on the basis of soft law. It could be the case that one of the international committees requires its members to enact a legal obligation to require all senior managers in all authorised firms in their jurisdiction to be a member of such a body, but the difficulty is that there is no single international regulatory committee which covers all jurisdictions and all financial sectors. It is therefore very difficult to see how membership of any such body could be made legally mandatory on a global basis.

22.4 Even if such a body were to be created within the UK, where membership could be made mandatory, it is difficult to see what the creation of such a body would add to the existing regulatory regime. Particularly for those individuals in firms which are dual-regulated by both PRA and FCA, the introduction of a third regulatory body which would be imposing the same duties would add an unnecessary level of complexity. There would also be the risk of double jeopardy if each were to bring enforcement actions under similar rules with respect to the same acts or omissions. Further, if there were a difference between the rules of the professional body and those of the jurisdiction in which the individual member were operating, then the individual would necessarily find themselves in the situation in which compliance with one set of rules would put them in breach of another. It is difficult to see how this would be an improvement on the current situation.

Cost

23. Understandably, there is considerable cost in pursuing individual actions. What changes do you think could be made in order to ensure that cost does not act as a deterrent in pursuing all but the largest cases?

23.1 Unless a cap were imposed on the fees that lawyers representing both regulators and defendants could charge, it is difficult to see how overall costs can be constrained. As noted above (para 1.4.8), in the Pottage case, seven senior lawyers acted as representatives for parties in the Upper Tribunal alone: one QC and counsel for the FSA, one QC and counsel for Pottage, and three counsel and two solicitors for UBS. The costs are likely to have exceeded by significant measure the £100,000 sought in fines.

23.2 Whilst overall costs are difficult to contain, there are different options for how those costs are allocated.

(i) Defendant pays - requiring the defendant to pay the regulators' costs regardless of the outcome of the case has the advantage of ensuring that the regulators' costs are always covered, but could have perverse incentive effects if left to operate untrammelled: regulators could be incentivised to pursue weaker cases, secure in the knowledge that their costs will always be covered by the other side. It would also be regressive, with the costs burden having a greater impact on smaller firms.

(ii) Loser pays – this is broadly the position at common law and has the advantage of ensuring that the regulator only takes cases which have a good chance of success, though it may act as a deterrent to taking more marginal cases, particularly against large firms who are likely to run up significant legal costs which the regulator risks bearing should it lose.

(iii) Each bears their own - requiring each side to bear their own costs regardless of the outcome has the advantage of helping each side to have greater control over the costs it will ultimately bear, even if it will not limit costs overall, and is likely to have the least adverse incentive effects on regulators to bring enforcement actions.

As noted, these options as to allocation of cost would not of themselves address the overall level of cost of taking enforcement actions, however.

International

24. Do you think introducing additional criminal, civil or regulatory sanctions would have an impact on the international competitiveness of UK banks?

Only if such standards resulted in the hiring of sub-standard managers. For the reasons outlined in the response to question 1 above it would depend on the selected standard as well as on any efforts to improve the level of resources provided to the UK regulators for effective enforcement.

25. In your opinion, are there other legal or regulatory regimes that the Commission should be considering? Please provide your reasons for suggesting the applicable regime.

25.1 The Australian Securities and Investments Commission (ASIC) mentioned above (para 16.1), provides an example of a public agency which is responsible for taking actions against directors and officers for breaches of duty. An analysis of their experience in bringing such actions, and on any effect it may have had on the incentives for individuals to become directors, could provide a useful comparison.

Other

26. The regulator has an extensive range of enforcement powers but is arguably hesitant in using those powers. What are your views on the introduction of sanction(s) that could be imposed against the regulator to the extent they do not deploy their powers appropriately?

26.1 There are three key questions to be addressed: (i) who would have the power to bring an action to impose the sanctions, (ii) what those sanctions should be, and (iii) which body should determine whether or not they should be imposed.

26.2 In constitutional terms, in order to preserve the independence of the regulator, any determination of whether or not a sanction should be imposed should lie with the courts, not with the executive or with Parliament. Giving the executive or legislature powers to sanction regulators would be a significant compromise of the principle of independent regulation, which has become so embedded that the House of Lords Committee on Regulators has described it a ‘quasi-constitutional principle’ (*Report on UK Economic Regulators*, HL 189-I, para 6.44).

26.3 Regulators are already subject to accountability through the courts. Enforcement decisions against individuals or firms by the FSA (and incoming regulators) are appealable to the Upper Tribunal and then to the Court of Appeal. Statutory regulators are also public bodies and as such subject to public law. There is already the possibility of bringing an action in public law against public authorities for failure to perform their statutory duties. However the courts have been understandably reluctant in to hold that public authorities should have taken certain actions, such as arrest suspects sooner, but failed to do so. As for who can bring such actions, the rules of standing to bring actions in public law are wide, and so it is open to any interested party to bring such an action within the relevant time-limits.

26.4 In addition, regulators are already subject to a wide array of non-judicial accountability arrangements, including to Parliament, and if legislation so permits, are subject to scrutiny by the NAO. Moreover, the executive and legislature together have the ultimate sanction – they can abolish the organisation altogether, as they have with the FSA.

Therefore we do not agree that regulators should be subject to any additional sanctions, and would argue strongly against any sanctions which contravened the principle of independent regulation.

27. What are your views on applying different sanctions for different types of directors – for example, non-executive directors?

27.1 Sanctions necessarily take account of the role and function of a director and therefore will vary in application as between executive and non-executive directors. If the question is concerned with whether *criminal liability* should only be applicable to some types of director – say executive rather than non-executive, then there are reasons both for and against this. It may be justifiable to exclude part time non-executives from such a criminal regime as they are not likely to be responsible directly for the actual misconduct in question and, because of the limited remuneration for these positions, may be more likely to be deterred from service. On the other hand, egregious failures to monitor and discipline executive directors or to respond to red flags or to ensure that control systems are in place may be just as blameworthy as operational misconduct and clearly have grave social implications. Whether it is appropriate to exclude non-executive directors is a function of the selected standard. If the standard is a demanding negligence standard of criminal liability then on balance we would argue that they should be excluded. If the standard is a recklessness or higher fault-based standard the arguments may be tipped in favour of not making any distinction between executive and non-executive directors.

28. Are there any other measures or legal/regulatory changes that the Commission should consider?

28.1 We consider that there are three key sets of measures that the Commission should consider. These relate to:

- Redefinition of corporate objectives and identification of to whom directors own their duties, with particular recommendations for ring fenced banks
- Remuneration for managers, particularly in ring fenced banks
- Culture and ethics

Structural Incentives and Risk Taking: objectives and duties

28.2 In our view there is much scope to improve bank conduct and culture by more effectively addressing the ex-ante incentives of banks and their managers and directors rather than by focusing on less effective ex-post liability rules - whether criminal or civil. By incentives we refer to much more than the remuneration arrangements of managers and bank employees, though we would include these. Note also that when we think about these incentive arrangements we need to ask whether we need different incentive structures for banks that are deemed to be systemically important. The imposition of additional corporate governance arrangements for regulated financial institutions under SYSC and APER recognises that financial institutions are in many ways 'special' and so require additional regulation beyond the corporate governance requirements that apply to companies in general. We would argue that systemically important institutions, and in particular ring fenced banks, are even more 'special'.

28.3 We would argue that the structural incentives generated by UK corporate law are worthy of further consideration by the Commission, at least within the context of the regulated financial sector. UK company law is often described by as shareholder friendly as compared to other corporate law regimes, such as those found in the United States or in Germany. This view is correct. For example, in the United Kingdom in all companies, including banks and financial institutions, the directors must exercise corporate powers to promote the interest of shareholders. When the company is solvent, the interests of other groups such as those of creditors, employees and society at large should be considered and taken into account by directors but only to the extent that they further the interests of shareholders. The corporate objective in the UK is correctly described as a shareholder primacy objective, sometimes referred to the UK as enlightened shareholder value objective. In many other jurisdictions, both continental European and American, the corporate objective which directors should pursue is better described as a pluralistic or multiple interest objective, where the interests of shareholders, creditors and employees are to be balanced with no one constituency is given overall priority. When it comes to shareholder rights the UK is firmly situated at the shareholder primacy end of the spectrum. For example, shareholders have mandatory rights to remove directors without cause by simple majority vote and 5% of the shareholder body may instruct the board to call a meeting. Again in the US and the Germany the rights given to shareholders are less powerful.

28.4 One response to the crisis has been to call for greater shareholder involvement (see, eg., the UK Stewardship Code and in some instances for more shareholder rights (see, for example, US 'say on pay' rights). However, there is good reason to doubt the appropriateness of this strategy in relation to banks and some empirical evidence to support these doubts. Shareholders in banks that benefit from the States "too-big-to-fail" (TBTF) subsidy have the wrong risk taking incentives. It is well known that shareholders who benefit from limited liability have an incentive to increase the risk profile of the company in which they hold shares. In non-financial companies this is not thought to be problematic as the debt providers discipline any attempt to increase the risk profile of the company. But in banks that benefit from the TBTF subsidy creditors do not discipline the banks because they assume they will get repaid even if the banks fail – because the State provides formal (deposit insurance) and uncosted informal guarantees. Importantly, this means that for a diversified shareholders it may be

rational to encourage managers to "bet the bank". For managers whose are required to promote the success of the company for the benefit of the shareholders they comply with their duties if they increase the banks risk profile at the expense of the ultimate non-adjusting creditor –the state.

28.5 This means that within systemically important banks that benefit from the TBTF subsidy the focus on shareholder value and rights in UK company law is not appropriate. Accordingly, there is concern that UK company law gives legitimacy to the very activity that we want to discourage and provides legal support for the culture which needs to be changed. If diversified shareholders have the wrong incentives in TBTF banks we must ask what sense it makes to prioritize the interests of bank shareholders over the interests of other constituencies – most importantly depositors and the State.

28.6 We should also consider whether it would make sense not to strengthen shareholder rights in such banks but to weaken them. There is some empirical support for the view that strong shareholder rights increase bank risk taking and the probability of bank failure. Ferreira, Kershaw, Kirchmaier and Schuster ('Shareholder Empowerment and Bank Bail Outs' available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2170392) show that in the United States banks with stronger shareholder rights were more likely to be bailed out than those with weaker shareholder rights and more likely to engage in riskier banking activities. In the United States core corporate law rights – such as rights of removal and the right to call a shareholder meeting are optional. This means that it is possible to identify banks with weaker shareholder rights that are very different to UK banks and banks with stronger shareholder rights more similar to the UK position. This paper codes the weaker and stronger banks and then analyses the comparative probability that these different banks will be bailed out. This finding may be subject to different interpretations discussed in the paper, but an important possible explanation is that direct or indirect shareholder pressure supported by strong shareholder rights results in more risk taking than in banks with weaker shareholder rights where managers could resist that pressure.

28.7 There is therefore a case to revisit the effect of corporate law on bank conduct. In particular, we suggest that there is a need to consider whether directors of regulated financial institutions, or a sub-sector of them, should be required to give equal weighting to the interests of all corporate constituencies when they act and to correspondingly consider whether it would be appropriate to weaken shareholder rights in financial institutions that have such a corporate objective (D. Awrey, M. Blair and D. Kershaw, 'Between Law and Markets: Is there a Role for Culture and Ethics in Financial Regulation, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2157588). For example, the shareholders right to remove directors in the middle of their term could require a simple majority of the outstanding shares rather than a majority of the votes cast at the meeting.

28.8 It may be that if such changes are deemed worthy of exploration further consideration should be given to whether they should only be applicable to ring-fenced banks or to financial institutions that benefit from a TBTF subsidy as it is only in those banks where the shareholder focus generates these incentive problems.

28.9 It could be argued that by requiring directors to owe their duties to everyone, they will in effect hold them to no one, as those interests are often likely to conflict. Whilst we do not agree that this argument is fatal to the proposal, an alternative option could be to specify the hierarchy of interests to whom directors of banks, or at least ring-fence banks, owe their duties. The crisis made a number of features of the financial system clear, one of which was that the interests of shareholders in banks are diametrically opposed to those of deposit-holders. Shareholders have a limited amount to lose and

everything to gain from the risk-taking of managers. Deposit-holders have everything to lose and very little to gain.

28.10 It could therefore be specified in legislation that directors of ring-fenced banks owe their duties primarily to deposit-holders, and only secondarily to shareholders. It is recommended that this amendment apply to the directors of ring-fenced banks, as they are a clearly definable set of institutions, and it is those banks which are in effect underwritten by the tax-payer. Requiring directors to owe their duties to deposit holders would make it clear that they were not to engage in conduct which, although profitable, could ultimately harm deposit-holders. It would also give leverage to regulators who through their supervisory interventions require the bank to act or to refrain from acting in certain ways, as banks would not be able to argue that their behaviour was justified in the interests of shareholders.

28.11 There are examples from other jurisdictions where companies themselves have, in agreement with regulators, amended their hierarchy of duties. In Australia, the legal services regulators have required Australia's two publicly listed legal practices to state in their prospectuses, constituent documents and shareholder agreements that their primary duty is to the court; their secondary duty is to the client; their tertiary duty is to the shareholder; and that where there is a clash between the Legal Profession Act 2004 (under which lawyers owe their primary duty to the court) and the Corporations Act 2001 (under which directors owe their duties to their shareholders), the former will prevail.

28.12 The Australian position is not completely satisfactory, as there remains a tension between two sets of legislative provisions. However it does provide an illustration of how legislation could be used to realign the duties of directors, at least in ring-fenced banks, so as to bring them closer in line with the public policy objectives that the regulatory regime is seeking to pursue.

Remuneration in Systemically Important Banks

28.13 Regulating remuneration has clearly been at the forefront of regulatory responses to the crisis. The primary regulatory response has been to ensure that bank remuneration is aligned with long term economic interests of bank and bank shareholders. For example, to limit cash bonus payments and other performance related pay and to ensure that bonuses and other performance based remuneration vests or is paid over a longer period of time. However, there is still a case to revisit remuneration regulation in relation to the most systemically important banks, which for these purposes we assume are the ring fenced banks.

28.14 Any performance-based pay arrangements that are linked to financial or equity based targets generate incentives to exploit the TBTF subsidy and incentives to engage in socially excessive risk taking. This is the case in a ring fenced retail bank as it is in any current universal bank. As HBOS but also Lehman show, socially excessive risk taking can take place through commercial lending activity.

28.15 If a primary goal of regulation is to ensure that a core set of retail banks can perform basic financial intermediation and provide a reliable payments system, then the Commission should consider whether in these ring fenced banks senior management should only be paid by salary with no bonus or performance related pay at all or at most the sort of bonus structure that would be payable in the public sector. It would also need to provide that any pension provision could not vest prior to retirement age or unexpected ill health. Such banks would be less innovative, daring and creative. But

they are likely to be safe. Their managers would have incentives to keep shareholders happy but not to take unwarranted risk that could jeopardize what for them would be the most important asset: keeping their job in a solvent bank. Such managers would not be interested in exploiting any gaps in the ring fence or allowing a connected investment bank to influence the ring fenced retail bank's activities. Indeed it is likely to drive separation - but internally by the individuals who know the banks rather than by regulators who are inevitably at a significant informational disadvantage. See generally: D. Kershaw, T. Kirchmaier and E. Schuster, "Its About the Incentives, Stupid" available at: <http://www2.lse.ac.uk/newsAndMedia/commentAndOpinion/2012/07/ItsAboutTheIncentivesStupid.aspx>

Culture and Ethics

28.16 There is an increasing acceptance by senior bankers, at the level of rhetoric at least, that the industry needs to build a more ethical culture. However, building ethical cultures is not easy, and is hard to reconcile with the 'eat what you kill' or even 'devour your own young' culture of the financial industry. Ethical behaviour is 'other regarding' behaviour, eg behaviour which marked by integrity and fair dealing, acting in the best interests of clients and being aware that your actions may have consequences for non-contracting parties.

28.17 Obligations to uphold such standards of behaviour have been in place in the regulatory realm for nearly 25 years- they were first articulated in regulatory rules in 1988, and have been present in equitable duties for far longer. Nonetheless, what it means to behave 'ethically' to investors is contested. In the retail markets, for every claim by the regulator that firms have failed in their suitability obligations, for example, there is a counter-claim by firms that regulators are imposing retrospective regulation. In the wholesale markets, any deviation from 'caveat emptor' is closely contested. One person's misselling is another's fair market transaction.

28.18 So to build an ethical culture two things are needed: to build an agreement on just what 'ethical behaviour' requires in any particular instance, and to develop organisational cultures in which those principles are upheld. As to how regulation can help to build an ethical culture, from decades of research into organisational behaviour, including regulatory compliance, we know the following:

- (i) that for both individuals and organisations, behaviour is shaped by the interaction of internal and external factors. For individuals those internal factors are their own ethical sense; for organisations it is its own structures, systems and culture. External factors in both cases arise from the social and market context in which those individuals and organisations interact with one another;
- (ii) that as a result of this interaction, an individuals' personal ethical sense is socially derived – it is shaped by immediate interpersonal interactions and by broader social factors – in particular those of the organisations in which they work;
- (iii) with respect to organisations' ethical culture – the 'ethical whole' is not the sum of the parts, ie., it is not the sum of the ethical cultures of those individuals within the organisation. Organisations are comprised of individuals, but individuals alone cannot necessarily withstand the structures, processes and ethos of the organisation. As a result, those who may be quite ethical in their lives outside work may behave unethically in their professional lives. We have seen how organisational structures and processes reinforce self-interested norms

rather than those which are 'other-interested' – notably remuneration structures. After decades of mis-selling banks are finally realising that paying salespeople by volume can be counter-productive for the firm, not just contrary to the interests of investors;

(iv) that for cultural change to occur, it has to come from the top, and it has to be 'mainstreamed' throughout the organisation, not siloed off into 'compliance' or 'risk' divisions, but even if senior management do attempt to introduce change, organisations are difficult things to manage and to run – the leaders of large organisations face the same problem as regulators do in attempting to 'manage at a distance' – problems of scale and scope, complexity and delegation. Further, what it means to be 'ethical' is not always clear;

(vii) as a result, organisations send contradictory signals about what behaviour is expected; those lower down may not trust senior management to behave ethically themselves either to clients or internally, and their HR practices can reinforce this lack of trust – for example, employees at UBS recently found out they had been sacked because their passes did not work in the morning – not an HR strategy which obviously demonstrates a 'caring' culture which builds loyalty.

28.19 Thus whilst the primary driver of ethical culture has to be the firm itself, regulators have a role in promoting that culture in a number of ways.

28.20 First, there needs to be far closer supervisory attention to internal processes, systems and structures. Admirably the FSA has been an innovator in using regulatory techniques to improve culture in retail investment firms. The FSA's 'Treating Customers Fairly' initiative is designed to use firm knowledge and resources to design systems and processes which ensure compliance with the general objectives specified by the FSA (See J. Black, 'The Rise (and Fall?) of Principles Based Regulation' in K. Alexander and N. Moloney (eds) *Law Reform and Financial Markets* (Cheltenham: Edward Elgar, 2011); J. Black 'Outcomes Focused Regulation – The Historical Context' in A. Hopper QC and G. Treverton-Jones QC, *Outcomes-Focused Regulation* (The Law Society, London, 2011). Through a combination of management by-in, FSA enforcement action and the conversations and engagement by employees with process design it is thought (hoped) that cultural norms consistent with the specified objectives will form and become embedded with the firm. We think that there is clear scope to extend this project into other areas of financial services, including wholesale activities (see D. Awrey, M. Blair and D. Kershaw, 'Between Law and Markets: Is there a Role for Culture and Ethics in Financial Regulation,' available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2157588).

28.21 Second, there needs to be greater supervisory attention to building a common set of expectations as to what ethical behaviour consists of in different situations. Ethical scenario analysis and ethical stress-testing within organisations could be a way for regulators and firms to examine and address ethical weaknesses, in much the same way as it is used in other areas of risk management. The results could have implications for regulatory strategy and serve to increase awareness within organisations. In order to ensure consistency across the industry, there would need to be agreement on the most ethical conduct and outcomes in the scenarios to be tested – a likely difficulty given how difficult it is to define ethics but the approach could at least raise the profile of ethics within firms and across the industry as a whole, and form part of its dialogue with regulators.

Please note

Each submission should:

- clearly state at the top which individual's or organisation's views the submission represents (which may be different from the particular person who sends it)
- begin with a short summary in bullet point form;
- have numbered paragraphs; and
- be in Word format with as little use of colour or logos as possible.

A copy of the submission should be sent by e-mail to bankingstandards@parliament.uk and marked "Banking Standards inquiry". There is no need to send a hardcopy.

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