



The Law Society

Sanctioning the Directors of Failed Banks

Response to HM Treasury Consultation

September 2012



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1. Introduction

This response has been prepared by the Law Society of England and Wales (the Law Society) which represents over 140,000 solicitors in England and Wales. The Law Society negotiates on behalf of the profession and lobbies regulators, governments and others.

This response has been prepared with assistance from the Law Society's Money Laundering Task Force, Banking Law Reference Group and Company Law Committee.

The Law Society welcomes the opportunity to respond to HM Treasury's consultation on sanctions for the directors of failed banks.

2. General comments

As the events of the last five years have shown, the failure of a bank will have significant and far-reaching consequences for the economy, business and the Government. The Law Society appreciates that HM Treasury, UK businesses and the general public therefore wish to ensure that those responsible for the failure of a bank are held to account.

There is a range of existing criminal and regulatory measures available to deal with individuals and corporate entities who engage in criminal activity or otherwise breach acceptable standards of conduct as prescribed by regulation. In recent years both the Financial Services Authority (FSA) and the Serious Fraud Office (SFO) have demonstrated a greater willingness to use those existing measures in a more robust manner. The financial sector itself has recognised that effective sanctioning of bankers who act in breach of existing criminal and regulatory requirements is essential for the maintenance of public confidence.

However, the Law Society believes that the measures proposed in this consultations undermine fundamental and well-established principles of justice, and pose significant practical difficulties. Several of the measures outlined in the consultation overlap with existing powers that UK regulators have to hold financial institutions to

account - many of which were given to regulators in the aftermath of the last financial crisis.

The Law Society is concerned about the lack of clarity surrounding the proposed measures. For example:

- There is no definition of "failure" in relation to banks. Some major UK banks are recipients of Government bail-out money or have been taken over by Government, while the source of privately sourced emergency funding for other banks are currently being investigated by law enforcement. It is not clear whether both 'rescue' requirements would be covered by these proposals or not.
- The target of these proposed new measures is also unclear - the consultation refers interchangeably, to 'directors', 'senior executives', 'board members' and 'senior managers'.

This lack of clarity is particularly problematic given the severity of the proposed sanctions, which potentially deprive individuals of their right to work or their liberty. When such strict sanctions are proposed, it is crucial that the offences are carefully and tightly defined to avoid penalising innocent individuals.

3. Regulatory intervention

HM Treasury proposes introducing a rebuttable presumption that the directors of a failed bank are not suitable to hold senior executive positions in other financial institutions.

Alternatively, HM Treasury suggests introducing detailed regulatory guidance to the effect that if an applicant has previously been a director of a failed bank, this should have a material bearing on the regulator's assessment of their suitability and competence under the approved persons regime.

HM Treasury states that two key problems for regulators seeking to hold individuals to account are:

- lack of clarity about who was responsible for failure; and
- the absence of an agreed standard to which key roles should be performed.

HM Treasury therefore proposes two sets of supporting measures. The first involves clarifying management responsibilities. The second involves the regulatory duties of bank directors.

We address each of these proposed measures in turn below.

3.1. Rebuttable presumption of unsuitability

The Law Society accepts that there is some precedent for using the approach of a rebuttable presumption in relation to company directorships and undisclosed bankrupts. However, the Law Society believes that the approach suggested by HM Treasury is wider than these existing provisions and presents several practical difficulties.

The proposal does not take into account the diversity of roles that company directors may have. Different directors may have been appointed at different

times and for different reasons. All of these factors may have a bearing on their potential culpability.

If the proposed presumption were to apply automatically on failure of the bank, this would logically mandate the immediate removal of the existing directors, which could leave the administrators/liquidators without access to their (potentially) key knowledge and expertise.

Individuals may struggle to gather the evidence necessary to rebut the presumption if they have already left the bank and no longer have access to documents and other relevant material. The problem is particularly acute where the cause of a bank's failure is a complex set of inter-related circumstances, some of which may have been outside the control (and possibly the knowledge) of a particular director. Gathering such evidence could be time-consuming and costly, and in some cases not possible at all for individual directors. This may mean that the director is unable to prepare a proper case to rebut the presumption, which raises obvious issues of fairness.

On the other hand, law enforcement and the FSA have a variety of powers that can be used to compel the production of documents and other material, which they would then be in a position to disclose to the director and receive comment upon in the normal course of assessing that director's fitness to take on another 'authorised' role.

The concept of "senior executive in a bank" needs to be clarified given the variety of management structures across financial institutions. There also needs to be a clear definition of the situations in which a bank can be said to be "failed" for the reasons outlined above.

Clarification of whether the presumption will apply only to those individuals who are directors at the point at which the bank fails or whether it would apply to previous directors of the bank (and, if so, over what timeframe), is necessary for the following reasons:

If the presumption were to apply only to individuals who were directors at the point when the bank 'failed' then:

- directors might be incentivised to abandon a distressed bank before it failed (even though not responsible for the bank's failure) to avoid the risk of the presumption applying, leaving the bank without the experience that could prove most essential to ensuring the bank's continuing survival; and
- a rebuttable presumption may also lead to difficulties in recruiting well-qualified people to try to rescue failing banks; potential new directors may be deterred by the fact that, if the bank fails despite their best efforts (e.g. it is unsalvageable for reasons beyond their control), then they will automatically be disqualified from taking up a new role in another bank, whilst those responsible for the bank's distressed state escaped the presumption.

If on the other hand, the presumption were extended back in time to former directors who left the bank within a prescribed amount of time before it failed:

- clarity is required on how and when the presumption would apply to a director who before the bank's failure had received approval to carry out a director's role at another institution. Lack of certainty surrounding the status of that approval would clearly also disrupt the functioning of the second institution; and

- clarity is required as to what right of challenge would be available in respect of such a revocation. Under proposals in the draft Financial Services Bill, a challenge to approval decisions would not give rise to full Tribunal rights.

The Law Society is firmly of the view that the existing Financial Services and Markets Act 2000 regulatory regime, including the 'fit and proper' test applicable to all persons undertaking approved person roles, provides adequate scope for a regulator to withdraw approval or refuse to sanction future appointment of individuals.

3.2. Further regulatory guidance

The FSA can already take an individual's success or failure in previous roles into account when determining approval applications. In this regard, we note that the FSA has recently begun interviewing candidates for approval in certain situations in order to establish their competence and suitability for the role they are applying for.

The Law Society believes that the FSA's approach is appropriate and is uncertain about what further guidance in this area would add, although we believe that further guidance is to be preferred over the proposals for a rebuttable presumption.

3.3. Clarifying management responsibilities

HM Treasury proposes that there should be either:

- clearer regulatory requirements about individuals' responsibilities and the standards required of individuals performing key roles; or
- a firm-based approach, whereby the onus would be on firms and individuals to provide a detailed written statement on the responsibilities and duties of each role.

The Law Society can see the attraction of clarifying the responsibilities of management roles. Such clarification may help to identify who should be held responsible for a particular failure and to establish causation.

A regulator-led approach risks creating a "one size fits all" approach to the myriad of management roles and structures applied in different banks, which may reduce legitimate flexibility and efficiency.

The FSA Handbook already provides for a firm-led approach, with firms required to maintain a clear and appropriate record of the responsibilities of its directors and senior managers (SYSC 2.2 and SYSC 4.4.3). It is not clear what further guidance is contemplated. A review of the way in which these requirements are applied in practice across different firms would help to inform any decisions about what, if any, further guidance or requirements might be necessary or appropriate. Some guidance as to frequency of updates might also prove helpful.

3.4. Changing the regulatory duties of bank directors

HM Treasury proposes two changes in this area:

- explicitly requiring banks to run their affairs in a prudent manner; and
- requiring bank boards to notify the regulator when they become aware that there is a significant risk that the bank will not be able to meet the threshold conditions for authorisation.

It may be difficult to assess what constitutes 'prudent' in any given context – particularly given that banking necessarily involves some degree of risk taking. Because an assessment of prudence would require a judgment to be exercised about the decision-making process (itself a matter of judgment), there is a greater need for clarity as to what is required.

The FSA Statement of Principles already requires approved persons to act with due care, skill and diligence when carrying out approved functions and to notify the regulator of material developments. The FSA has recently acted pursuant to these existing requirements in relation to conduct arising out of the recent financial crisis. In September 2012, Peter Cummings (former head of corporate banking at HBOS), was fined £500,000 for not acting with due care, skill and diligence as a result of his role in the collapse of HBOS. He was also banned from working in the banking industry. This suggests that the FSA's existing powers are appropriate and being used by the FSA to target inappropriate conduct. The Law Society does not see what the proposed duties would add.

4. Criminal sanctions

There has been extensive public comment seeking criminal action to be taken in relation to the recent financial crisis. The Law Society appreciates the level of detail contained in this section of the consultation, better enabling a balanced and well-informed discussion on this subject.

The Law Society appreciates the necessity of holding individuals to account where their actions have been responsible for the failure of a bank. However, there are already extensive criminal sanctions, provisions under the Companies Act 2006, regulatory requirements and robust processes in place to deal with such matters. Since the financial crisis the FSA has taken a more robust approach to enforcement which has resulted in greater civil penalties for approved persons, including (notably) higher fines and bans from working in the industry.

The Law Society does not accept that there has been a sufficient failure of the existing remedies and processes which would warrant such wide ranging new offences and the extension of criminal sanctions to matters which for good reason have been regarded as regulatory issues.

The consultation acknowledges that criminal sanctions already exist for offences that involve fraud and other forms of dishonesty, and instead considers whether managerial misconduct may be subject to new criminal sanctions. The options proposed are:

- a strict liability offence for being a director of a bank when it fails;
- negligence;
- incompetence;

- and recklessness.

As set out in our opening remarks, the Law Society agrees with HM Treasury that creating an offence on any of the four grounds set out above would pose practical problems, including:

- establishing causation - e.g. that a particular decision led to the failure of the bank concerned;
- deciding which individuals involved should be prosecuted;
- the length and cost of investigations, particularly assembling the evidence needed for prosecution; and
- the volume of material that may need to be analysed.

4.1. Strict liability

This approach involves creating a strict liability offence of being a director of a failed bank "at the relevant time". HM Treasury recognises that there are difficulties with creating a strict liability offence, including:

- It would be controversial to impose criminal penalties on individuals who were not plainly at fault (e.g. the bank may have been a victim of outside events).
- Difficulty in defining "relevant time" and what is meant by "failure".
- Issues of fairness - a strict liability offence would penalise a director who had been brought on board to rescue a bank while allowing a director who was responsible for decisions that contributed to failure, but had departed the bank before it failed, to escape liability.
- Strict liability seems likely to deter people from taking up board appointments in rescue situations.

The Law Society concurs with HM Treasury's reasoning and agrees that a strict liability offence would not be appropriate. We would add that creating a strict liability offence would also cut across the well-established director disqualification scheme.

4.2. Negligence and incompetence

HM Treasury argues that creating an offence based on negligence or incompetence would demonstrate that society is not prepared to tolerate such conduct. However, HM Treasury recognises that this approach may be problematic for the following reasons:

- Regulators can already take action against individuals for negligence or incompetence. Regulators can also take action against firms where an individual's negligence or incompetence means that the firm failed to comply with regulations or meet the threshold conditions for authorisation.
- Negligence and incompetence can already give rise to civil law actions in tort or breach of contract.
- In some cases it is possible for company shareholders to take action against individual directors.

- It is more difficult to mount a successful criminal prosecution than for a regulator to take action under the Financial Services and Markets Act 2000. As a result, a new offence that imposes criminal sanctions may not have clear advantages.

The Companies Act 2006, is another example of how negligence on the part of management can be effectively redressed. Under that Act, a company and also members are able to seek redress from a director where that director has been in breach of his any of the general duties of a director as set out in the Act. The most relevant of the duties in this context are the duty to promote the success of the company and the duty to exercise reasonable care, skill and judgement. The consequence of a breach, or threatened breach, of any of the general duties are the same as if the corresponding common law rule or equitable principle applied. The Act also allows members to bring derivative proceedings in the name of and for the benefit of the company, subject to Court approval, in respect of causes of action arising from an actual or proposed act or omission involving negligence, default, breach of duty, or breach of trust by a director.

The Law Society concurs with HM Treasury's reasoning and agrees that negligence and incompetence would not be appropriate foundations for criminal sanctions in this area.

4.3. Recklessness

HM Treasury suggests that an offence based on recklessness would make bank directors think carefully before making risky business decisions and make it clear that society will not tolerate such conduct. However, HM Treasury acknowledges that, in order to define what constitutes recklessness, there must be a clear idea of what constitutes normal or non-reckless risk-taking.

The Law Society agrees there are clear difficulties with such an approach.

Recklessness is already widely used in the criminal law, particularly in relation to statements (for example, section 2 of the Criminal Justice Act 1987 and section 2 of the Fraud Act 2006). However, HM Treasury's approach would mean extending recklessness to areas that have previously been regarded as regulatory matters.

If recklessness was used as the basis for an offence, prosecutors would have to decide, possibly years after the decision was taken, whether it was reckless or not at the time. Business decisions will always involve a degree of risk; the commercial environment is unpredictable and, while a decision may be characterised as reckless with the benefit of hindsight, at the time it is taken it may appear to be a perfectly reasonable course of action. The risk of hindsight judgment must be very high in these circumstances.

An offence based on recklessness would make businesses much more risk-averse. Businesses may become wary of making bold but legitimate business decisions in case those decisions are categorised as reckless later on. A recklessness-based offence could also lead to the possibility of a failure to make a bold but legitimate decision being classed as reckless conduct in certain circumstances. Such concerns may mean that company decision-making processes become more time-consuming and conservative and this may impact negatively on growth, which would be in direct conflict with the Government's growth agenda.

For all of these reasons, the Law Society does not support any of the proposed new criminal offences.