MAYER • BROWN

Legal Update
October 2013

Amendments to the UK Financial Services (Banking Reform) Bill

This alert considers the amendments the government proposed to the Financial Services (Banking Reform) Bill on 1 October 2013 in the light of the recommendations made by the Parliamentary Commission on Banking Standards. It focuses on the anticipated introduction of the new Senior Persons Regime and its ramifications across the financial services industry and the possibility of its wider application.

The financial crisis sparked a series of drastic reforms of the banking sector and compelled the government to commence a review of the sector's professional culture and practice. To this end, the government established the Independent Commission on Banking ("**ICB**") in June 2010 to advise it on how to reduce systemic risk and to propose structural reforms to promote financial stability. Its findings and recommendations were published in the Vickers Report in September 2011. The government supported many of the recommendations, notwithstanding some nuances, and these were incorporated into the Financial Services (Banking Reform) Bill (the "**Bill**") which was introduced into Parliament on 4 February 2013. The Bill focuses on the ring-fencing requirements to separate retail and investment banking but, following the recent amendments, now also includes reforms such as the introduction of a new senior persons regime and a new criminal offence of reckless misconduct. The Bill is primarily an enabling bill, conferring powers on the Treasury and the relevant regulators, primarily the PRA, to implement the underlying policies.

As part of their pledge to make the banking sector more resilient against losses and impose tougher standards on the banking industry, the government also recruited the Parliamentary Commission on Banking Standards ("**PCBS**"), established on 17 July 2012, to opine on the legislation. It published further recommendations to reform the banking sector in its paper, "*Changing banking for good*" on 19 June 2013. The recommendations included the following:

- a new Senior Persons Regime to replace the current Approved Persons Regime ("**APR**");
- a new Licensing Regime to apply to other bank staff whose actions or behaviour could seriously harm the bank, its reputation or its customers and ensure they are subject to the full range of enforcement powers;
- the time limit for disciplinary action extended to six years;
- a new criminal offence for senior persons found guilty of reckless misconduct in the management of a bank;
- a new remuneration code to better align risk and reward; and
- a new power for the regulator to cancel all outstanding deferred remuneration, along with unvested pension rights and loss of office or change of control payments, for senior bank employees in the event of their banks needing taxpayer support.

The government underlined its commitment to reform by proceeding to implement the first four recommendations of the PCBS by making amendments to the Bill whilst it was at the committee stage in the House of Lords. The amendments must be considered by the Lords and reviewed by the Commons so further changes are possible. Once the Bill receives Royal Assent, the policy framework will be established but the detail will be provided by rules which will be made by the regulators. The FCA published in its response[1] to the PCBS recommendations on 7 October 2013 and anticipated that the rules will be available for consultation in 2014 and implemented in 2015.

1 "The FCA's response to the Parliamentary Commission on Banking Standards" can be found here: http://www.fca.org.uk/static/documents/pcbs-response.pdf

The Senior Persons Regime

In the opinion of the PCBS, some of the failings in the banking sector were attributable to the lack of individuals' sense of responsibility and lack of accountability of senior managers. They branded the APR a failure and a "*complex and confused mess*"[2]. They proposed a new regime consisting of a two-tier Senior Persons Regime and a Licensing Regime which would be underpinned by a new set of banking standards rules.

The first element, the new Senior Persons Regime, is intended to make "*individual responsibility in banking a reality, especially at the most senior levels*"[3] and to discourage misconduct. The government accepted the PCBS' view that the APR was a failure and it emphasized its commitment to establishing a new framework for individuals within banks.

One of the shortcomings of the APR was said to be its failure to demarcate individual responsibilities sufficiently clearly. This led to uncertainty about who should be held to account for specific breaches. The new regime will hinge on ensuring that individuals who undertake the main responsibilities in a bank are identified, understand their roles and formally accept them.

Under the current regime, individuals must be approved by the appropriate regulator[4] before they can be appointed to a post which is deemed a "controlled function" in an authorised firm. The PCBS recommends maintaining this procedure so that individuals must apply to the regulator should their responsibilities be considered a "senior management function" and thus fall within the remit of the Senior Persons Regime. A function will be deemed as such by the relevant regulator if it involves managing an aspect of a firm and those aspects could involve serious consequences for the firm, for wider business or other interests in the UK. The definition requires the relevant regulator to adopt a risk-based approach and should capture those individuals that are actually responsible for managing the banks. It is thought that the definition will apply to a smaller group of people than those deemed to be in Significant Influence Functions under the APR and will focus on those that truly run the banks and apply to those who should 'fall on their swords' should enforcement action arise[5].

The new regime requires those with a senior management function to submit a "statement of responsibilities" which must clearly define the perimeters of their individual responsibilities. The form and substance of the statement remains to be determined by the regulators' rules. Subsequent approval will be necessary should there be any significant changes to the areas within the firm for which the individual becomes responsible. This is a change from the APR which only required a one-off approval upon admission and addresses the criticism that the current regime was merely an "initial gateway" rather than requiring periodic review. The FCA's response to the PCBS report suggests that the regulators should have the right to grant approval for a limited time period only or subject to certain conditions, such as if the individual needs to acquire a specific skill to carry out the role, if this is deemed necessary in order to advance the regulators' objectives. The PCBS also proposed that when a Senior Person leaves a firm they should provide a handover certificate detailing how they fulfilled their responsibilities under the regime. The FCA agreed that this would be a useful tool in assessing the fitness and propriety of senior persons and has pledged to take it into account when formulating its rules and guidance.

Scope

Unlike the APR which captures a wider strata of the financial services industry, including for example investment firms, the new Senior Persons Regime will apply only to UK deposit-taking institutions, that is, banks, building societies and credit unions. This raises the possibility of sectoral and jurisdictional regulatory arbitrage, particularly when it is considered alongside the Vickers requirement of functional subsidiarisation of deposit-taking activities.

The APR will be maintained for institutions outside the scope of the new Senior Persons Regime.

2 Changing banking for good - Parliamentary Commission on Banking Standards (Conclusions and recommendations) http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/2704.htm

3 Changing banking for good - Parliamentary Commission on Banking Standards (Summary) http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/2703.htm

4 The FCA or PRA as appropriate to the institution.

5 It is anticipated that all PRA-controlled functions and some FCA-controlled functions will be senior management functions.

Burden of Proof

Within the context of the Senior Persons Regime and in line with the objective of enhancing individual accountability, the government will adopt the PCBS recommendation that it reverse the burden of proof to ensure that Senior Persons can be held accountable. This means that the burden is on Senior Persons to demonstrate that they took all reasonable steps to prevent a contravention occurring or continuing in the part of the business for which they are responsible. Failure to do so may lead to a charge of misconduct. The PCBS recommended that it should be possible to instigate enforcement action against the institution of an accused individual but this has not been incorporated in to the Bill. In such cases, an individual's statement of responsibility becomes particularly valuable in assessing the level of culpability.

Time Limit

The government has also adopted the PCBS recommendation to extend the time limit for commencing disciplinary action. The Bill doubles the time period within which disciplinary action can be taken against both non-approved individuals and approved persons from three to six years, starting from the date of the alleged misconduct. This has also been supported by the FCA.

Criminal Offence

The government has supported the PCBS recommendation that criminal penalties should be introduced for bankers that behave irresponsibly. The Bill creates a criminal offence for reckless misconduct in relation to the management of a bank. It is hoped that this will deter individuals and ensure individual accountability.

The elements of the offence are:

- that the individual is covered by the new Senior Persons Regime;
- the individual took a decision which led to the failure of the bank or failed to take steps available which would prevent him taking such decision;
- the behaviour falls far below the standard that could reasonably be expected of a person in that position; and
- the senior person was aware of a risk that the implementation of the decision may cause the bank to fail.

The offence is necessarily prescriptive in that the individual must be subject to the Senior Persons Regime and the bank must have failed. It is, therefore, hoped that an individual should be in no doubt as to whether they could potentially be liable for their actions. If convicted of this offence, an individual could face an unlimited fine or imprisonment for seven years. The FCA notes that the elements of the offence resemble those of corporate manslaughter and that some of the other serious offences in the financial services sphere carry similar penalties upon conviction. Further, this only applies to banks and building societies whereas the other proposals include credit unions.

The Licensing Regime

The second tier of the new regime is the Licensing Regime. The PCBS deemed this further level necessary to capture a wider population of employees who are also able to cause harm to the bank, its customers or its reputation. The regime will be based on a revised set of Individual Standard Rules which will be developed by the regulator and consulted on in 2014. Individuals under the Licensing Regime will not require pre-approval from the regulator but firms would be responsible for applying the fitness and propriety test.

The Licensing Regime will also focus on personal accountability by establishing a double register for both the Senior Person and Licensing Regime to detail any disciplinary action taken by a bank on their staff. The FCA endorses this but notes that it will be subject to proportionality such that entries pertaining to staff under the Licensing Regime will be less comprehensive. The relevant regulator will then assess whether further enforcement action is necessary. It is hoped that these recommendations will encourage banks to take more responsibility for the conduct of more of their staff.

Comment

The government has shown its commitment to restoring the faith in the banking sector by adopting many of the recommendations of the PCBS, notwithstanding the Bill already being before Parliament. The FCA and Bank of England responses to the government's proposals showed broad support for many of the amendments. For now, the government has rejected the PCBS calls to extend the scope of the Senior Persons Regime beyond the banking sector but has not ruled out incorporating some of the provisions into the APR so that there may be some subsequent application to non-deposit-taking institutions.

We have commented on the risk of sectoral and jurisdictional regulatory arbitrage that might arise from the imposition of more onerous requirements on UK deposit-taking entities and questions could be raised as to whether this could damage the competitiveness of the UK banking sector. It is important to bear in mind, however, that legislation from the European Union may add further layers to the regulation of banks. In November 2011 the European Commission commissioned a report on whether EU level structural reform of banks would enhance financial stability. The product of this was the Liikanen report which was published in October 2012 and, similarly to the recommendations in the UK, proposed corporate governance reforms as well as the mandatory separation of investment and retail banking. The report was not greeted with enthusiasm in continental Europe, however, and it has been suggested that the UK may be the only European country to adopt anything close to the Liikanen proposals. The Commission is expected to adopt a legislative proposal for structural reform shortly but much of the EU still favours a universal banking model and, particularly in the light of recent German and French legislative proposals, the Commission may focus simply on separating banks' proprietary trading from their retail activities.

In the meantime, UK deposit-takers will not receive further detail of the corporate governance reforms the Bill will introduce until the regulators consult on their draft rules but what is apparent is a desire to ensure that individuals will be held accountable for their behaviour and will be unable to rely on collective decision-making. Deposit-takers will need to review their corporate governance framework and may also need to review their organisational structure and chains of command so that the allocation of risk and responsibility is clear. The wide application of the Licensing Regime and the new power to take enforcement action against (non-approved) employees in banks where they have contravened the conduct rules or where they are knowingly involved in a breach by the firm brings a new class of individuals into the regulatory arena. This could fundamentally change the way deposit-takers recruit, manage, train and reward staff. Further, those individuals within the scope of the Senior Persons Regime will, as much as the regulators, require a clear statement of their responsibilities. Recent statistics show an increasing willingness on the part of the regulator to bring successful civil and criminal actions against individuals. The reversal of the burden of proof in the civil sphere could give further encouragement to both the FCA and the PRA. Against this background, it will not be surprising if such assumptions of responsibility encourage senior managers to adopt a more probing and challenging approach to the staff and operations the decisions relating to which they will be required to defend, perhaps even in a criminal court of law.

If you have any questions about any of the issues raised in this update, please contact one of the lawyers listed below or your usual point of contact:

David Sahr
T: +44 20 3130 3496
E: dsahr@mayerbrown.com

Mark Compton
T: +44 20 310 3388
E: mcompton@mayerbrown.com

Alexandria Carr
T: +44 20 3130 3398
E: acarr@mayerbrown.com

About Mayer Brown

Mayer Brown is a global legal services organisation advising clients across the Americas, Asia and Europe. Our presence in the world's leading markets enables us to offer clients access to local market knowledge combined with global reach.

We are noted for our commitment to client service and our ability to assist clients with their most complex and demanding legal and business challenges worldwide. We serve many of the world's largest companies, including a significant proportion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. We provide legal services in areas such as banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory & enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

OFFICE LOCATIONS

AMERICAS
- Charlotte
- Chicago
- Houston
- Los Angeles
- New York
- Palo Alto
- Washington DC

ASIA
- Bangkok
- Beijing
- Guangzhou
- Hanoi
- Ho Chi Minh City
- Hong Kong
- Shanghai
- Singapore

EUROPE
- Brussels
- Düsseldorf
- Frankfurt
- London
- Paris

TAUIL & CHEQUER ADVOGADOS
in association with Mayer Brown LLP
- São Paulo
- Rio de Janeiro

Please visit www.mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

0643fin
October 2013