Regulatory Duties for Directors in the Financial Services Sector and Directors' Duties in Company Law- Bifurcation and Interfaces

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Abstract

Directors in the financial services sector are now subject to direct and enhanced obligations to the financial services regulators in the UK. These obligations, worded broadly, are in some respects similar to how directors' duties under company law are framed. Directors in the financial services sector are accountable to regulators in respect of the discharge of these obligations and the history of enforcement by financial services regulators in the UK has shown that tough sanctions are meted out. Directors' duties in general company law are however owed to the company as a whole, and are enforced by the company, shareholders through derivative litigation or liquidators at winding up. Civil enforcement against directors in company law has been quiet in the UK in spite of the revelation of senior level failures in banks in the global financial crisis of 2007-9.

Questions may be asked as to why the directors' duties regime in company law seems ineffective to address senior level weaknesses in the banks embroiled in crisis in 2007-9, and continue to appear unable to hold senior figures to account in the more recent episodes[2] of bank malpractice and mis-selling. Further, with the advent of the regulatory regime governing senior persons' conduct in the financial services sector, it is queried whether the regulatory regime will become the main means of discipline for senior persons, making the directors' duties regime irrelevant.

This article examines the relationship between the two legal regimes, and seeks to eludicate the role of regulatory governance of directors in the financial services sector alongside the directors' duties regime in company law. This article argues that directors' duties in company law serve different purposes from the regulatory regime for senior persons' conduct in the financial services sector, and hence the approach taken to separately regulate directors' conduct in financial services is a correct one. The regulatory regime is intended to encourage greater senior level internalisation of important public policy objectives that cannot be introduced in company law. It will be argued that the regulatory regime should be seen as a distinct mode of prudential and conduct regulation in financial services, and not as a form of governance that eclipses the enforcement of directors' duties under company law. The interface between the two regimes should not result in the marginalisation of the company law regime and can indeed lead to better mitigation of information asymmetry for the purposes of civil enforcement of directors' duties under company law. The article however acknowledges that due to the role of D&O insurance, it may make no practical difference what in theory is achieved by either regime. The article also provides some cautionary notes regarding the impact of the regulatory regime on directors' conduct which will inevitably spill over and shape the discharge of directors' duties under company law.

Introduction

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[2] Such as benchmark manipulation in the LIBOR cases and foreign exchange rigging by bank traders.

A person who accepts a board appointment to a corporation will be subject to directors' duties in company law. These broadly-worded duties, now codified in the Companies Act 2006, apply across the corporate sector irrespective of industry. Directors' duties are enforceable by the company, by shareholder derivative actions, or to a certain extent by liquidators in winding up. The Secretary for Business also has the power to take disqualification actions[3] against directors and breaches of duty could form the basis of such actions. By and large, private litigation is the main mechanism by which directors can be called to account for discharge of their duties. In the aftermath of the global financial crisis, many are intrigued by the lack of teeth in the mechanism of private litigation to call directors of nearly-failed banks in the UK to account. First, there is an issue of the remote possibility of success due to difficulties in establishing a breach of duties. Next, there also seems to be reluctance on the part of shareholders to sue. This may be because they have already taken a battering in the loss of corporate value in the crisis and it is uncertain how further litigation would adversely affect corporate value. Further, shareholders may also be uncertain as to the extent of compensatory potential in directors' D&O (directors' and officers' liability insurance), and are hence hesitant to sue.

One response to the seeming impotence in the directors' duties regime in company law is to introduce regulatory intervention to re-regulate senior management conduct in financial services in order to enhance individual responsibility. Legislators and the financial services regulators in the UK have now introduced a regime[4] that imposes specific duties on directors and senior management of financial institutions. Individuals in breach of such duties would face regulatory enforcement resulting in fines and disqualifications from working in the financial sector. Such enforcement is now being carried out rigorously by financial service regulators and it could even be argued that this regime almost eclipses the importance of the general regime for directors' duties in company law.

This article examines why the company law regime of directors' duties seems irrelevant to holding directors to account in the wake of the crisis. It also examines whether the introduction of a new regulatory regime for directors and senior managers at financial institutions would combat the perceived weaknesses of the general directors' duties regime in company law. It critically discusses the application of the company law regime and suggests that the company law regime serves a compensation purpose, which is different from the objective of the regulatory regime. The regulatory regime is premised on a deterrence purpose. This article argues that regulatory duties and liability regimes for directors of financial institutions are not a substitute for corporate governance and civil enforcement of directors' duties in company law, and should be understood as a distinct regime. Hence, the article supports the perspective that the regulatory regime has introduced a bifurcation of obligations imposed on directors under company law and financial regulation. However, the interface of these obligations does produce certain ramifications. Active regulatory supervision and enforcement with respect to directors' obligations may result in the

[3] Company Directors Disqualification Act 1986 as amended by Rules in 2002 and further amended in 2013. See John Lowry and Rod Edmunds, 'Directors Duties and Liabilities: Disqualifying 'Unfit' Directors at Banks? Political Rhetoric and the Directors' Disqualification Regime' in Iris H-Y Chiu and Michael McKee (eds), *The Law on Corporate Governance in Banks* (Cheltenham: Edward Elgar 2015).

[4] Senior Persons Regime, see PRA and FCA, *Strengthening Accountability in Banking: A New Regulatory Framework* (July 2014); PRA, *Strengthening individual accountability in banking and insurance – responses to CP14/14 and CP26/14* (23 March 2015); FCA, Approach to Non-Executive Directors in Banking and Solvency II Firms & Application of the Presumption of Responsibility to Senior Managers in Banking Firms' (23 Feb 2015).

marginalisation of civil enforcement or private litigation generally as a form of market-based governance, although this need not be the case. Further, regulatory regime will introduce incentives for directors to behave in certain ways that would affect their accountability under company law in certain ways. This article however does not deal with the issue whether and how the company law regime should be reformed.

A. UK Banking Crisis and Directors' Duties

This Section first examines why directors' duties in company law is apparently unable to address the senior level weaknesses in the banks that nearly failed in the UK in 2007-9. It will argue that the specific issues that have arisen have both strategic and public interest dimensions and hence may not be best dealt with by enforcement under the directors' duties regime in company law.

Three significant banks in the UK failed in the global financial crisis 2007-9. The first, Northern Rock, was a mortgage lender with a large market share. It operated on a risky originate-to-distribute business model which relied on short term money market funding to finance its extensive mortgage writing business. The bank avoided rigorous prudential controls which would have limited its mortgage lending business by quickly repackaging mortgage assets into complex securities which were then distributed to the wholesale market. The bank essentially functioned as a conduit between the retail borrowers and the wholesale securitisation market, capturing enormous growth in the mortgage market share. However it rapidly cascaded into trouble when the money markets dried up and the securitisation appetite dipped due to subprime mortgage defaults in the US. Following a request by the bank for the Bank of England's emergency liquidity facilities, the bank quickly lost public confidence and was nationalised by the UK government to stem panic in early 2008. The then-Financial Services Authority produced a report[5] reflecting upon what went wrong at Northern Rock and with regulatory supervision. Certain doubts were voiced regarding the Chairman of the Board and the Chief Executive in terms of their competence and decisions made. However neither individual has been subject to any individual liability under directors' duties or regulatory law.

Next, the Royal Bank of Scotland and Halifax Bank of Scotland both tethered at the brink of failure in early 2009. The Royal Bank of Scotland had been growing aggressively through large-scale acquisitions, such as of National Westminster Bank in the UK in 2000. In May 2007, Fred Goodwin the ambitious Chief Executive led the bank to acquire Dutch bank ABN-AMRO, over-bidding for it in order to edge rival Barclays out of the race. The deal was completed deal quickly without adequate due diligence carried out on ABN-AMRO's assets. By early 2009, significant losses surfaced on the bank's books due to the absorption of losses from ABN-AMRO's extensive securitised assets portfolio. Although the then-Financial Services Authority criticised the senior management for poor risk decisions and governance culture in its report[6] on the Bank, no individual has been subject to any individual liability under directors' duties or regulatory law. However, Fred Goodwin was stripped of an earlier-awarded knighthood.[7]

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[5] FSA Internal Audit Division, *The Supervision of Northern Rock: A Lessons Learned Review* (March 2008).
[6] FSA, *The Failure of the Royal Bank of Scotland: Financial Services Authority Board Report* (Dec 2011).
[7] 'Former RBS Boss Fred Goodwin Stripped of Knighthood', *BBCNews* (31 Jan 2012).

The Halifax Bank of Scotland was however a casualty of the global financial crisis only because the crisis crystallised the failure of an already dangerous business model.[8] The Bank has been pursuing reckless growth and expansion and had been underwriting corporate loans with poor due diligence and standards. The losses already sustained on the bank's books were a disaster waiting to happen even if the global financial crisis had not occurred. Although the Parliamentary Commission tasked to look into banking standards criticised the Chairman, the Chief Executive and a number of Board members, only one individual, Peter Cummings, the Director of the Corporate Finance division who led the business into writing enormous sums of bad corporate loans, was fined and disqualified by the then-Financial Services Authority.[9] No other individual has been subject to any individual liability under directors' duties or regulatory law.

Post the global financial crisis, a wave of conduct scandals was unveiled in the banking sector. Banks such as Barclays were fined in significant amounts for rigging the London Inter-bank Offered Rate.[10] The Financial Conduct Authority, together with other international regulators also subject a number of banks including Barclays and RBS to record fines over foreign exchange market-rigging.[11] The Salz Review[12] which revealed unhealthy sub-cultures in the large and complex structures at Barclays also raised interesting questions- to what extent should senior management and the Board be responsible for toxic banking culture, as organisational culture depends so much on 'tone at the top'?[13]

It may be argued that personal liability regimes such as directors' duties in company law would have been exactly intended to dis-incentivise poor decision-making on Boards that translates into imprudent and improper conduct in various sections of the banks. So why is the directors' duties regime in company law apparently irrelevant in holding bank directors to account? There are a number of possible answers to the question: first, it could be argued that directors' duties in general company law are weak and inadequate to address the particular issues in risk and misconduct in the financial services sector. Second, it could be argued that the enforcement of directors' duties in company law is a weak form of enforcement too and such weaknesses have only been exposed in the wake of the global financial crisis. For example, Smith and Walter opined[14] in 2008, before the onset of the global financial crisis, that unless director liability regimes were reformed so that the personal liability of directors was enhanced, there would not be sufficient incentives to pursue prudent risk management in the corporate sector generally. Third, it may be argued that directors' duties in company law are not purposed towards dealing with the particular issues that have arisen in the financial sector, and so the company law regime is not unfit for purpose as such but it is unable to deal comprehensively with the issues that have arisen. This article is of the view that although the first argument is plausible, the second, i.e. weaknesses in enforcement is more salient. The article however prefers the third perspective, although this does not mean that the directors' duties regime need not be improved. Within the confines of this article, we will explain why the third

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[8] House of Lords and House of Commons Parliamentary Commission on Banking Standards, *'An Accident Waiting to Happen': The Failure Of HBOS* (4 April 2013).
[9] FSA, *Final Notice against Peter Cummings* (12 Sep 2012).
[10] John Gapper, 'Trading Floor Culture no longer Acceptable' *Financial Times* (London, 5 July 2012).
[11] 'UK regulator fines five banks \$1.7 billion after currency rigging probe', *Reuters* (12 Nov 2014); 'Banks hit by record fine for rigging forex markets', *The Guardian* (20 May 2015).
[12] Anthony Salz, *The Salz Review* (2013).
[13] Tim Hallett, 'Symbolic Power and Organizational Culture' (2003) 21 Sociological Theory 128.
[14] Roy C Smith and Ingo Walter, *Governing the Modern Corporation* (Oxford: Oxford University Press 2006), 281.

perspective can be supported and leave for another day the arguments regarding the weaknesses of the directors' duties regime in company law in general.

First, we discuss the possibility of enforcing directors' duties under general company law in the context of the particular issues that have arisen in the financial services sector- risk taking and management decisions, market misconduct and mis-selling practices. This article argues that the specific issues of prudential management that have arisen are issues that may expose contrary interests between the shareholders of the company and the general public interest. In this respect, the company law regime, which is a regime upholding directorial accountability primarily to its internal constituents, is not quite the appropriate regime to govern aspects of prudential management.

Examining the Application of Directors' Duties under General Company law to Risk Decisions at Banks and Financial Institutions

It is questionable if risk decisions made in the course of banking business may be in breach of directors' duties at all. The relevant duties to consider are the duties in sections 172 and 174 of the Companies Act 2006- the duty to promote the success of the company and the duty of care, skill and diligence. In jurisdictions where the business judgment rule applies to protect directors from being impeached for decisions that are commercial/business-oriented in nature, risk appetite and management decisions (unless neglected) could be regarded as business judgments that are not questionable by shareholders in civil proceedings.[15]

The duty to promote the success of the company under section 172 of the UK Companies Act 2006 is derived from the general duty of loyalty to act in the company's best interests.[16] Courts have generally been satisfied that if directors have acted in subjective belief in the best interests of the company, such belief held in good faith, then directors' decisions should not be questioned.[17] If the bank directors criticised in the regulators' reports above honestly believed their risk decisions to be in the interests of the company, especially in the context of a highly competitive financial market[18] where high risks and large returns are not uncommon, it would be difficult to impeach them for breach of director's duty with the benefit of hindsight. This interpretation of the directors' duty to promote the success of the company would likely achieve the same effect as protecting directors' business judgment, although subjective good faith is not applied in such a way as to ignore any sense of reasonableness.[19] In sum, the threshold would be rather high for impeaching a directorial decision genuinely held and which is not regarded as patently unreasonable.

[15] *In Re Citigroup Inc. Shareholder Derivative Litigation* 4 A.2d 106 (Del. Ch. 2009), based on the standard in *In re Caremark International Inc. Derivative Litigation* 698 A.2d 959 (Del. Ch. 1996).
[16] *Re Smith and Fawcett Ltd* [1942] Ch 304.
[17] *Regentcrest plc v Cohen* [2001] 2 BCLC 319; unless no reasonable director would have taken such a decision, see *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62.
[18] Arthur E Wilmarth Jnr, 'The Transformation of the Financial Services Industry: 1975-2000, Competition, Consolidation and Increased Risks' (2002) University of Illinois Law Review 215; Karen Ho, 'Disciplining Investment Bankers, Disciplining the Economy: Wall Street's Institutional Culture of Crisis and the Downsizing of "Corporate America"' (2009) 111 American Anthropologist 177.
[19] *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62; Andrew Keay, 'Good Faith and Directors Duty to Promote the Success of the Company' (2011) 32 The Company Lawyer 138-143.

As to whether the criticised bank directors would have fallen below the standard of care required under section 174 of the Companies Act 2006, it would have to be argued that they have either delegated risk management too far down the line and failed to pay attention to its importance, hence falling below the standard of care expected of them; or that their decisions are negligent, falling below the standard of what a reasonable person in the position of director would have carried out. In terms of the argument regarding excessive delegation and lack of monitoring, the American shareholders' litigation against Citigroup[20] was dismissed as the shareholders failed to show how, in spite of systems and procedures put in place for Board monitoring, directors have still not held their delegates such as senior managers to adequate accountability. The failed UK banks have also put in place systems for risk management, although not all of them adequate with the benefit of hindsight.[21] It is highly difficult for directors to be impeached for failure of care and diligence due to delegation, unless in a patently egregious case such as Barings[22] in the 1990s.

As to whether directors in the failed banks could be made liable for 'negligent decisions' in relation to risk, there may be scope for saying that the directors of Northern Rock and HBOS tolerated poor underwriting standards and took on excessive numbers of bad loans in order to grow their loan books, and it could be argued that the lack of adequate due diligence carried out by RBS in connection with the acquisition of ABN-AMRO was negligent. Paolini argues that bankers were aware that the stakes were high and they were on the verge of recklessness with risk-taking.[23] However, these weaknesses have to be judged in the context of the complexities of transactions and the efficiencies required for decision-making at banks and financial institutions in a fiercely competitive global market. It could be argued that high risks were taken in the context of trust in sophisticated, albeit novel risk management techniques. Hence, it may be uncertain if directors at the banks mentioned above would be judged as falling below a reasonable standard of care. Further, the management of large global banking groups is itself a challenging and complex task,[24] and hence directors have to be judged against a standard of reasonableness in their contexts and positions. Further, as regulators did not prescribe mandatory expertise qualifications for Board members, it would be difficult to allege that certain directors, such as those not financially trained, have fallen below a reasonable standard of care in decision-making. It is noted that the then-FSA particularly doubted if Matt Ridley, a zoologist, was equipped to Chair Northern Rock before its demise. However, there is an advantage to having a balance of skills on the Board, it would be difficult to allege that non-financially trained members of the Board would necessarily lack skill and diligence for the job.

Further, it is questionable how individual liability may be pursued against directors where decisions are the product of collective deliberations and responsibility. Decisions such as risk appetite and

[20] *In Re Citigroup Inc. Shareholder Derivative Litigation* 4 A.2d 106 (Del. Ch. 2009), based on the standard in *In re Caremark International Inc. Derivative Litigation* 698 A.2d 959 (Del. Ch. 1996).
[21] Eg House of Lords and House of Commons Parliamentary Commission on Banking Standards, *'An Accident Waiting to Happen': The Failure Of HBOS* (4 April 2013) criticises HBOS' silo-based system and the dismantling of a centralised risk management function.
[22] *Re Barings plc* (No 5) [1999] 1 BCLC 433.
[23] Adolfo Paolini, 'Lending Sub-prime and Advising on Financial Investments from a D&O Insurance Perspective' (2012) Journal of Business Law 432.
[24] 'Banks have become too complex to manage', *Financial Times* (7 Nov 2014).

business strategy may often be collective Board decisions,[25] and it has been opined by the Court that in larger organisations where decisions are collectively made, it is less likely that individuals would be called to account for such decisions. The Upper Tribunal decision in *Arch Cru*[26] seems to confirm that liability may attach to individuals more easily in smaller firms where responsibilities are clearly defined.

However, what is more salient is that it is unlikely that the arguable issues of directors' duties may be tried in court as it is unlikely that the banks or their shareholders will take derivative litigation[27] against the directors that oversaw the banks during the crisis.

In the aftermath of the global financial crisis, many affected banks underwent senior management changes, but new management is unlikely to have pursued former management members as litigation expenses may be imprudent given the need to recover the banks. Further, shareholders may not be keen to mount derivative litigation as it is counterproductive to pursue litigation that may have the effect of depressing the value of the corporation even further after taking the battering from the global financial crisis.[28] Further, it would seem contradictory to lie in shareholders' mouths to sue directors who have precisely served shareholders' interests by pursuing risky and high-returns business strategies.[29] Moreover, banks and shareholders would be uncertain whether claims against directors, if successful, would be met by directors' D&O insurance.[30] The certainty of recovering under D&O policies very much affects incentives to sue. For example, if courts were to hold that reckless risk-taking decisions are in breach of the duty to promote the success of the company in good faith, will any finding of bad faith fall outside of the scope of cover of D&O insurance? Even if directors can be called to account in case law jurisprudence, the compensation objective may not be met if the relevant D&O cover is not applicable.

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[25] Edward Walker-Arnott, 'The Role and Composition of the Board' in Iris H-Y Chiu and Michael McKee (eds), *The Law of Corprate Governance in Banks* (Cheltenham: Edward Elgar, 2015).

[26] *Arch Financial Products LLP & Ors v The Financial Conduct Authority* [2015] UKUT 13 (TCC) (19 January 2015).

[27] Andrew Keay, 'The Public Enforcement of Directors' Duties : A Normative Inquiry' (2014) 43 Common Law World Review 89-119.

[28] The incentives to sue directors are generally weak, whether we refer to the company or to shareholders in derivative litigation. See Hirt's comprehensive thesis on weak incentives and imperfect alternatives in vesting the cause of action, Hans Christoph Hirt, 'The Company's Decision to Litigate against Directors: Legal Srategies to Deal with the Board of Directors' Conflict of Interest' (2005) Journal of Business Law 159.

[29] Much research shows the correlation between shareholder friendly Boards and heightened risk-taking in banks, see Andrea Beltratti and René M Stultz, 'Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation' (July 2009) NBER Working Article No 15180 http://articles.ssrn.com/sol3/articles.cfm?abstract_id=1433502; Reint Gropp and Matthias Köhler, 'Bank Owners or Bank Managers: Who is keen on Risk? Evidence from the Financial Crisis' (January 2010) European Business School Research Article No 10-02 http://ssrn.com/abstract=1555663; David H Erkens, Mingyi Hung and Pedro Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2012) 18 Journal of Corporate Finance 389.

[30] As companies have been allowed after 1989 to indemnify directors, indemnification arrangements and D&O insurance have grown in demand. However, the scope of D&O insurance has changed over time, and although most cover would include breaches of duty due to negligence, many exclude intentional, wilful , illegal or criminal behaviour. See Chris Parsons with an early survey of the market, in 'Directors' and Officers' Liability Insurance: A Target or a Shield?' (2000) Company Lawyer 77. However, there may be incentives for shareholders to sue those directors who have evaded regulatory action and therefore seem to be in a good position to compensate if required, eg see the 12,000 strong group litigation organised by RBS Shareholder Action group against former directors Tom McKillop and Fred Goodwin, at http://www.rbosaction.org/. In sum, the decisions in private litigation could be very strategic in nature on the part of shareholders.

Taking a broader perspective, it could be argued that what is sought to be achieved by enforcement of directors' duties via private litigation is compensation for the company, and hence the protection of value for the capital providers of the company. The overarching objective for directors' duties, stated in section 172 of the UK Companies Act 2006, is to promote the best interests of the members as a whole. This has been explained in policy articles and commentary[31] as relating to long-term wealth creation by the company, and hence, the corporate objective[32] is one of maximising the corporation's own survival and wealth, chiefly for the benefit of its capital-providers. The objective of the directors' duties regime is not quite in the same spirit as the corporate governance changes desired in the wake of the crisis.[33] What is desired by policy-makers and public opinion is that bank directors take into account of the systemic risk of their risk decisions and therefore act in such a way as to preserve overall financial stability in public interest. Such an objective is not what is pursued by the directors' duties regime. The maximising of wealth or even survival for an individual institution can sometimes be contrary to the general interest of financial stability, as individualistic actions may result in zero-sum games, collective depression of asset prices, situations of illiquidity and panic.[34] Hence, what may be in fulfilment of directors' duties under company law need not be in sync with public interest such as in financial stability. Hence, on one level it is arguably right to say that there may be a deficit in civil enforcement against directors in the wake of the UK banking crisis; on another level this deficit is not the same concern as that of policy-makers and the public when they demand that directors' behaviour be more responsible and accountable.

Examining the Application of Directors' Duties under General Company law to Market Malpractices in the Financial Services Sector

One could perhaps understand that it may be tricky to impeach directors for strategic risk decisions. However, where market malpractices and mis-selling is concerned, would not directors be held to account under the directors' duties regime for these abuses carried out by the firm even if not directly committed by themselves?

Where market abuse such as the rigging of financial benchmarks such as LIBOR or foreign exchange rates is concerned, evidence so far has pointed to the existence of rogue groups[35] and sub-cultures in financial institutions that are responsible for such behaviour. For example, former UBS banker Kweko Adoboli's indictment for market abuse.[36] In such cases, it may be argued that directors are

[31] Referred to as the 'enlightened shareholder value' approach, see Department of Trade and Industry (DTI), *Company Law Reform – White Article* (2005); Andrew Keay, 'Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective' [2006] Lloyds Maritime and Commercial Law Quarterly 335; 'Tackling the Issue of the Corporate Objective : An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach' (2007) 29 Sydney Law Review 577, *The Enlightened Shareholder Value Principle and Corporate Governance* (Oxford: Routledge 2012).

[32] Even if we do not adopt a pure shareholder primacy view of the corporate objective, see Sarah Worthington, "Shareholders: Property, Power and Entitlement" Parts 1 and 2 (2001) 22 Company Lawyer 258 and 307; Andrew Keay, *The Corporate Objective. Corporations, Globalisation and the Law* (Cheltenham: Edward Elgar Publishing 2011).

[33] David Walker, *A Review of Corporate Governance in UK Banks and other Financial industry Entities: Final Recommendations* (26 November 2009).

[34] Katharina Pistor, 'A Legal Theory of Finance' (2013) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2262936.

[35] See for example, 'Former Barclays Employees Charged over LIBOR Rigging', *Bloomberg* (18 Feb 2014).

[36] 'Kweku Adoboli jailed for fraud over £1.4bn UBS loss', *BBCNews* (20 Nov 2012).

unlikely to be held for breaches of duty of loyalty or care where determined deviants in the firms commit regulatory infringements and crimes, unless there is a patently inadequate system of oversight and monitoring as in the *Barings* case mentioned above. Even mis-selling practices in firms have been attributed to certain individuals, for example, Fabrice Tourre[37] in connection with the Goldman Sachs Abacus product, and Magnus Peterson in connection with the failed Weavering hedge funds.[38] However, it would be right to query whether directors could be made responsible for breaches of directors' duties in cases of large scale mis-selling[39] which reflects toxic firm culture. It is highly arguable that directors in such cases should be held to account for tolerating toxic and short termist practices of mis-selling that would ultimately damage the firm's reputation and entail longer-term cost associated with regulatory liability- arguably amounting to a failure in the duty to promote the success of the company. The failure to ensure a healthy culture in sales or to institute adequate conduct controls or monitoring may also arguably amount to a breach of the duty of care.

However, this article argues that it is unlikely that enforcement of directors' duties in connection with market malpractices or mis-selling by financial firms will be pursued. This is partly because the causal connection between the market malpractice and directors' decisions may be remote and hence there may not be clear cases for enforcement.[40] The main reason may be that there would be a lack of incentives to sue for breaches of directors' duties in such cases. Expensive litigation could damage the financial institutions' profitability further after huge regulatory fines have already been incurred. Further, compensation for the company may be uncertain if directors' conduct is judged in such a way as to fall outside of D&O insurance cover, and hence there would be hesitation to sue. Further, the firm may be cautious not to become antagonistic towards directors in an already difficult recruitment market for senior management in financial services. It may also be said that shareholders would have supported short termist decisions that improve profitability[41] even if such decisions were on the borderline of being acceptable. Hence, there would be no moral compulsion on the part of shareholders to sue in derivative proceedings against directors.[42]

The Irrelevance and Weaknesses of the Directors' Duties Regime in Company Law in Addressing Financial Sector Conduct?

The above has argued that in relation to the specific issues of financial sector conduct that has given rise to concern in the last 5 years, calling directors of such institutions to account under company

[37] 'Ex-Goldman Sachs trader Fabrice Tourre fined $650,000', *BBCNews* (12 March 2014).
[38] 'Weavering hedge fund founder Magnus Peterson jailed for 13 years over fraud', *The Telegraph* (23 Jan 2015).
[39] For example the mis-selling of personal protection insurance, see discussion in Eilis Ferran, 'Regulatory Lessons from the Payment Protection Insurance Mis-Selling Scandal in the UK' (2012) *European Business Organisation Law Review* 248 ; the mis-selling of interest rate swaps to small businesses, see FCA, 'Interest Rate Hedging Products' (2013) identifying 9 banks that needed to engage in compensation redress for aggrieved clients, at http://www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products.
[40] See discussion above relating to the difficulty in applying section 174 to directors regarding risk practices. A similar discussion would apply in this case.
[41] See citations in n25.
[42] This is not to mention that derivative proceedings are costly and cumbersome, see Arad Reisberg, 'Derivative Claims under the Companies Act 2006: Much Ado About Nothing?' in J Armour and J Payne (eds), *Rationality in Company Law: Essays in Honour of DD Prentice* (Oxford: Hart Publishing, 2009) at 17; Iris H-Y Chiu, 'A Confidence Trick: Ex Ante versus Ex Post Frameworks in Minority Investor Protection in the UK' (2014) 11 European Company Law 6.

law is likely to be challenging. One could argue that this is due to weaknesses in company law. For instance, directors are unlikely to be held to have breached their duty of care in delegating decisions to other levels as long as reasonable systems of oversight are installed. Such a threshold of care may allow directors to become 'less responsible' as long as certain procedures are in place, promoting a box-ticking culture[43] instead of a culture of engaged oversight. However, one cannot allege that standardised procedures are necessarily ineffective,[44] and one must take into account what directors at such a high level are able to do given their resources and the complex structures in many financial institutions. This article is not of the view that the directors' duties regime in UK company law needs no improvement- this area has been discussed extensively by other commentators[45]- but that in dealing with senior management responsibility for the specific issues of financial sector conduct that have arisen, the general regime of directors' duties is perhaps not the most appropriate platform. This is because the main ideological paradigm of company law is private in nature and centres upon capital providers' interests and is therefore not able to deal with the wider conceptions of public interest. Further, although one can argue that it is this narrow ideological paradigm that needs to be reformed, such reforms are fundamental and may have too many unanticipated ramifications. Hence, policy-makers have chosen to be rather cautious going down that route (rightly or wrongly).

The mainstream view is that the imposition of directors' duties in company law is to safeguard against managerial abuse that could damage the interests of the company, in particular the interests of the residual claimants[46] of the company, the shareholders. Directors also owe duties to creditors[47] in the twilight period of the company approaching insolvency, and so directors' duties in company law are premised to serve their capital providers' interests. Directors' duties are very much rooted in the micro-economic agency paradigm of corporate governance.[48] Hence, the private enforcement of directors' duties is for the purposes of addressing capital providers' interests, and the incentives for private enforcement therefore turn upon the likelihood of compensation and recovery, such as whether D&O insurance cover extends to the issue at hand. Private enforcement arguably does not relate to the social dimension desired of bank directors' responsibility in securing responsible firm behaviour.

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[43] Kimberly D Krawiec, 'Cosmetic Compliance and the Failure of Negotiated Governance' (2003) 81 Washington University Law Quarterly 487.

[44] Christine Parker and Vibeke Lehmann Nielsen, 'Corporate Compliance Systems : Could They Make Any Difference?' (2009) 41 Administration and Society 3.

[45] For example, Andrew Keay, 'Section 172(1) of the Companies Act 2006: An Interpretation and Assessment' (2007) Company Lawyer 106; 'Directors' Duties and Creditors' Interests' (2014) 130 The Law Quarterly Review 443-472; 'The Authorising of Directors' Conflicts of Interests : Getting a Balance?' (2012) 12 Journal of Company law Studies 129-162; Pey-Woan Lee, 'Serving Two Masters - The Dual Loyalties of the Nominee Director in Corporate Groups' (2003) J.B.L. 449-469; Paul Davies, "The Enlightened Shareholder Value and New Responsibilities of Directors" also at www.cclsr.law.unimelb.edu.au/ download.cfm?DownloadFile=665BC771-B0D0-AB80-E2535391273A455E at pp1-9.

[46] Armen A Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organisation' (1972) 62 The American Economic Review 777.

[47] *West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30; see Andrew Keay, *Company Directors' Responsibilities to Creditors* (Oxford: Routledge 2007); 'Directors' Duties and Creditors' Interests' (2014) 130 The Law Quarterly Review 443-472.

[48] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305.

The concern with the nearly failed banks in the UK was not just one of private compensation within the agency paradigm. It was an issue of knock on effects upon financial stability and thus an issue of public and societal proportions. Where financial sector malpractices and mis-selling are concerned, the harms caused are also of social proportions as not only individual losses are suffered, but market confidence and integrity have been damaged. As such, we may need a different regime that caters to interests in the public and social dimensions to govern senior management behaviour in banks and financial institutions. Perhaps a similar argument could apply to corporations with other systemic impact upon socio-economic life in general.

One could however argue that capital providers have also suffered in the episodes of wider dimensions mentioned above, and so why should the directors' duties regime not be used as a form of market-based discipline that can be used to achieve good for public and social purposes too? This line of reasoning would support reforming and strengthening the directors' duties regime so that private litigation and enforcement can be used to achieve compensatory purposes for capital providers first and foremost, and also achieve discipline for directors in the wider public interest.

This article is however of the view that shareholders' private litigation and enforcement against directors' duties would not achieve adequate governance over directors for the public interest objectives mentioned above, and in some cases could be contrary to the public interest needs in governing directors' conduct in financial services. In shareholders' litigation against directors, the issues of directors' conduct would centre upon shareholders' long-term financial interests. Commentators[49] have generally agreed that even though section 172 of the Companies Act 2006 obliges directors to consider a range of stakeholder interests, shareholder interests remain paramount and stakeholder interests are read subordinate to those, and cannot anyway be directly enforced. In such litigation, wider public and social interests in the directorial conduct of financial institutions cannot be given optimal emphasis.

Further, shareholder litigation may in some cases be totally contrary to the wider public and social interest in financial sector conduct. For instance, shareholder suits in the US such as against JP Morgan for acquiring Bear Stearns in 2007[50] or against Bank of America[51] for acquiring Merrill Lynch in 2009 ignore the wider interests of financial stability. Both acquiring banks ie JP Morgan and Bank of America bought Bear Stearns and Merrill Lynch respectively as brokered deals facilitated by the Federal Reserve in the interests of stemming systemic risk if Bear or Merrill should fail. However, they have been subject to shareholder litigation for the poor risk decisions taken at Bear and Merrill respectively. It may be argued that such shareholder actions to enforce directors' duties seem to be completely out of sync with the socio-economic interests underlying bank rescues and are contrary to the public interest dimension. These suits which ended in massive settlements have merely transferred wealth from the corporation to litigious and self-centred shareholders. Such lessons in the US are perhaps not the best learning examples for the UK. It is worth considering if shareholders

[49] See Paul Davies, "The Enlightened Shareholder Value and New Responsibilities of Directors" also at www.cclsr.law.unimelb.edu.au/ download.cfm?DownloadFile=665BC771-B0D0-AB80-E2535391273A455E at pp1-9; Andrew Keay,'An Analysis of Enlightened Shareholder Value in Light of Ex Post Opportunism and Incomplete Law' (2011) European Company and Financial Law Review. 445-475; Joan M Loughrey, Andrew Keay and Luca Cerioni , 'Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 Journal of Company law Studies 79-111.

[50] 'Bear Stearns Shareholders Settle Lawsuit for $275 Million', *Bloomberg* (7 June 2012).

[51] 'BofA pays $2.4 billion to settle claims over Merrill', *Reuters* (28 Sep 2012).

should be regarded as an appropriate constituent for enforcement of directors' duties in a context where wider financial stability concerns are also important.

It has been suggested that corporate governance reforms need to fundamentally recalibrate the agency-based legal duties imposed on directors, and legal duties that address directors' accountability to a wider slate of constituents and society should be introduced. Commentators such as Vasudev suggest that minimum Board responsibilities with respect to risk management need to be prescribed, such as:

> [R]eviewing, approving, and monitoring fundamental financial and business strategies and the performance of the company relative to those strategies; assessing major risks facing the company; and ensuring that reasonable processes are in place to maintain the integrity of the company and the corresponding accountability of senior management.[52]

The Parliamentary Commission of the UK House of Lords and House of Commons has also made a far-reaching suggestion: to impose a duty on individual directors to safeguard bank safety.[53] This suggestion was not ultimately taken up in legislation. Mülbert also suggests, due to the moral hazard effects of deposit insurance and potential bank bailouts, that directors should owe a duty to the Financial Services Compensation Scheme and to stakeholders, such as depositors and creditors.[54] Brittan, writing in the *Financial Times,*[55] also calls for banks bailed out by the state to incorporate a public purpose objective. The prospect of reforming the directors' duties regime in company law was consulted upon by the Business Department[56] and ultimately dropped.

This article suggests that the rejection of reforms to directors' duties in company law where the financial sector is concerned is a correct approach. If directors of financial sector institutions are subject to a specific duty of ensuring financial stability, this duty which has its genesis in socio-economic concerns would become conflated with the other shareholder-centric duties and become confused in character. It is questioned how courts would characterise and interpret such a duty. Further it would be inappropriate for shareholders to enforce such a duty, or at least shareholders would not be incentivised to enforce, given the discussion on the nature of shareholder concerns discussed above. Such a duty may not be meaningful unless stakeholders are given a standing to sue, but this opens up new questions in relation to how standing should be determined and whether there may be floodgates of opportunistic litigation that further damages the corporation as such.

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[52] PM Vasudev, 'Credit Derivatives and Risk Management: Corporate Governance in the Sarbanes-Oxley World' [2009] Journal of Business Law 331 at 351.

[53] House of Lords and House of Commons, *Changing Banking for Good* (Report of the Parliamentary Commission on Banking Standards) Vol 1 at para 110 (12 June 2013).

[54] Peter O Mülbert, 'Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms' (April 2010) ECGI Law Working Article No 130/2009 http://ssrn.com/abstract=1448118 accessed 5 March 2013.

[55] Samuel Brittan, 'Use the UK's state bank holdings to speed a recovery' *Financial Times* (London, 22 September 2011).

[56] Paras 249, 258, BIS, *Transparency and Trust: Enhancing the Transparency of UK Company Ownership and Increasing Trust in UK Business* (April 2014) at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/304297/bis-14-672-transparency-and-trust-consultation-response.pdf.

The ultimate reform approach taken in the UK was to introduce extensive regulatory duties for senior persons in financial sector institutions. This regime introduces regulatory duties for directors of financial sector institutions that are not applicable to the general corporate sector. Such a regime reflects the public interest dimension of these obligations and enforcement is pursued more appropriately by the UK financial services regulators, the Prudential Regulation Authority or the Financial Conduct Authority. The next Section discusses the regulatory regime.

In sum, the apparent irrelevance of the directors' duties regime in addressing the public interest in directorial conduct can be explained. This Part has explained why the company law regime of directors' duties seems irrelevant to hold bank directors to responsibility and account in the wake of the crisis. Although some weaknesses in the company law regime, particularly in private enforcement, are salient, the article's focus is not on how and whether the company law regime can be reformed and changed. It argues that reform and change that conflates the public interest objectives into the directors' duties regime is inappropriate and that the right approach has been taken to introduce a bifurcation of directors' regulatory obligations under the Senior Persons Regime. Section B discusses this Regime and Section C will sound a few notes of caution regarding the Regime.

B. Senior Persons Regime in Financial Regulation

In 2012, the UK instituted a Parliamentary Commission comprised of both Houses to inquire into how banking culture could be changed for good. The Parliamentary Commission is of the view that individual standards are key to enhancing banking culture and hence enhanced regulation of individuals must be introduced to change banking for good.[57] The Commission has however framed such reforms as being a 'special case'[58] and it remains to be seen if individual regulation could become justified for other important sectors.

The Parliamentary Commission proposed enhanced regulatory liability for senior persons and employees performing any function that 'could harm the bank'[59] as well as a special criminal liability regime for senior persons who have recklessly mismanaged a bank. The Financial Services (Banking Reform) Act 2013 has adopted much of the Parliamentary Commission recommendations. First, senior management must be approved with a statement of responsibilities and the failure to carry out such responsibilities means that specific liability will be attached to the relevant senior person.[60] The responsibilities allocated to each senior person will be according to a list of prescribed responsibilities that the PRA and FCA have established.[61] Second, senior persons are subject to a set of specific Conduct Rules that are more stringent than those applicable to other employees (albeit in significant functions) and senior persons would be liable for breach of the Conduct Rules, or where they are knowingly involved in a regulatory contravention by the financial institution concerned, or

[57] House of Lords and House of Commons, *Changing Banking for Good* (Report of the Parliamentary Commission on Banking Standards) (12 June 2013) at Vol I, para 116.
[58] Above.
[59] House of Lords and House of Commons, *Changing Banking for Good* (Report of the Parliamentary Commission on Banking Standards) (12 June 2013) at Vol II, paras 632-634.
[60] Section 60(2A), Financial Services and Markets Act 2000 as amended by the Financial Services (Banking Reform) Act 2013.
[61] PRA/FCA, *CP15/22 Strengthening Accountability in Banking: Final rules (including feedback on CP14/31 and CP15/5) and consultation on extending the Certification Regime to wholesale market activities* (July 2015).

where there is a regulatory contravention by the financial institution and the senior person is holding an office with responsibility related to the regulatory contravention.[62] In the third scenario, the senior person's liability is a form of strict liability by virtue of being responsible for overseeing an area where regulatory contravention occurred, whether or not such person is personally involved in the regulatory contravention. This form of liability is more stringent than that imposed on other employees, which is based on knowing involvement in regulatory contravention.

The Conduct Rules that the PRA and FCA will put in place for senior persons comprise of individual conduct rules that also apply to all licensed financial sector employees, and a set of Senior Management Rules applicable only to senior management to ensure due monitoring, oversight and ownership of responsibility.

Individual Conduct Rules:

Rule 1: You must act with integrity.

Rule 2: You must act with due skill, care and diligence.

Rule 3: You must be open and cooperative with the FCA, the PRA and other regulators.

Senior Manager Conduct Rules

SM1: You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.

SM2: You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant requirements and standards of the regulatory system.

SM3: You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.

SM4: You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.[63]

Although the Parliamentary Commission initially recommended that an individual senior person would only be able to defend against liability if s/he proves to the court's satisfaction that all reasonable steps have been taken to mitigate the effects of a specified failing, the Act seems to provide for strict liability, leaving negligence liability for the more serious criminal offence of mismanaging a financial institution into failure. The PRA and FCA indicates that in implementing the senior persons regime, they would take the approach of presuming responsibility when breach of the Conduct Rules or failure of designated responsibilities occurs, such presumption may be rebutted upon evidence that all reasonable steps to prevent the breach or failure have been taken.[64] Where senior persons are found to be liable, they could be imposed with a fine and/ or disqualified

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[62] Sections 66A, 66B, Financial Services and Markets Act 2000 as amended by the Financial Services (Banking Reform) Act 2013.

[63] PRA and FCA, *Strengthening Accountability in Banking: A New Regulatory Framework* (July 2014).

[64] PRA and FCA, *Strengthening Accountability in Banking: A New Regulatory Framework* (July 2014).

from performing similar functions in the financial sector. The disqualification sanction is particularly severe as it affects the career and livelihood of senior persons.

The Parliamentary Commission also proposed to enact a special criminal offence of recklessly mismanaging a bank for senior persons.[65] This is intended to reflect the need for a severe and credible public interest position in bank safety and soundness, but such prosecution would likely only be undertaken rarely only in the most severe of cases and not likely to be used to punish directors of small institutions. The Parliamentary Commission believed that requiring the *mens rea* of recklessness is apt as strict criminal liability would be overly-inclusive. An individual must be proved beyond a reasonable doubt to be in a mental state of 'recklessness' in managing the bank, the definition of such a mental state being well-established in general criminal law jurisprudence.[66] The offence of reckless mismanagement of a bank would only be alleged against an individual under such circumstances as bank failure with substantial costs to the taxpayer, lasting consequences for the financial system, or failures that have caused serious harm to customers.[67] Further, in order to ensure consistency and independence in the carrying out of enforcement in financial regulation, the Parliamentary Commission proposes that all enforcement functions to be housed in an independent body nested with the FCA but appointed by both the PRA and FCA.[68]

The 2013 Act has however deviated from the Commission's proposals.[69] It allows the PRA, FCA, Secretary of State or Director of Crown Prosecutions to institute criminal proceedings against senior management who have knowingly taken a decision for the business, being aware that a risk of failure could ensue, and in so doing has fallen below the standard of a reasonable person in his/her shoes. Such a decision must also have caused the failure of the financial institution. This means that a threshold slightly above negligence has been instituted for liability instead of recklessness. However, the Act provides that causation needs to be proved and so a strict liability standard is not applied. On balance the Act's position may be sounder as criminal recklessness is hard to prove where decisions taken in an organisation may be subject to herding behaviour, copying other successful institutions, or under myopic pressures pursuing profits and competitive edges. Such decisions could nevertheless be objectively negligent.

The Senior Persons Regime includes senior persons including directorial and C-suite officers. Although the SM Conduct Rules are broadly worded, the nature of the obligations imposed is oriented towards ensuring that ultimate decision-makers in financial institutions internalise public interest objectives in the running of such institutions. The aspect of the SM Conduct Rules that relate to securing effective internal control would compel senior persons to internalise the prudential regulation objective. The duties relating to securing regulatory compliance would compel senior management to take ownership of regulatory objectives. This article argues that the framing of directorial obligations towards public interest objectives such as financial stability and market integrity can only be achieved by the imposition of regulatory duties, as directors' duties in company law serve completely different purposes. The regulatory regime is intended to serve a deterrence

[65] House of Lords and House of Commons, *Changing Banking for Good* (Report of the Parliamentary Commission on Banking Standards) (12 June 2013) at Vol II at paras 1174-1186.
[66] Above at paras 1176-1179.
[67] Above at para 1183.
[68] Above at paras 1187-1202.
[69] Section 29, Financial Services (Banking Reform) Act 2013.

objective, to prevent financial sector mismanagement or misconduct from having an adverse impact upon socio-economic life. This is different from the private compensation objective in the directors' duties regime in company law.

Hence it is also apt that regulatory enforcement for breaches of senior management duties entail the consequences of fines and personal disqualification. The fines are paid into regulatory coffers and personal disqualification results in the removal of persons from the financial sector who are judged unable to help in securing regulatory objectives. The deterrent nature of regulatory enforcement has been reflected in a number of post-crisis individual enforcement decisions. Although those decisions were based on the former 'approved persons regime' (APER) that did not treat senior persons distinctly, some useful insights can be gleaned in terms of the nature and toughness of such enforcement.

Enforcement under the Former APER regime

In 2012, a high-profile enforcement action was carried out against the director of corporate finance at Halifax Bank of Scotland (HBOS), Peter Cummings.[70] Cummings[71] was the director of the Corporate Division of HBOS which needed government rescue in the global financial crisis of 2008-9. In late 2008, HBOS had suffered losses due to impairment of assets up to £7 billion out of which £4.7 billion were incurred by the Corporate Division. The massive losses made by the Corporate Division were due to excessive risk-taking by making loans that were highly risky, subordinated or sub-investment grade. Cummings pursued an aggressive growth strategy for the Corporate Division and was expanding HBOS' exposure to corporate credit although huge risks were taken. This would have required Cummings to institute and oversee a robust risk control and management system commensurate with the high risk growth strategy. The then-FSA alleged that Cummings was in breach of Principle 6 of APER i.e. discharging his functions without due care, skill or diligence. Although the then-FSA acknowledged that Cummings was not solely responsible for the growth of the Corporate Division which had been ongoing under the leadership of Cummings' predecessor, Cummings failed to ensure that an adequate system of control and risk management was in place to monitor the high levels of risk incurred. Hence, the then-FSA meted out a fine of £500,000 and banned Cummings for life from taking on controlled functions in the financial services sector.

The deterrence objective was also evident in high-profile enforcement against directorial personnel at Swinton Group Limited in 2014.[72] Swinton Group Limited provided basic insurance products for retail customers such as accidental personal injury insurance, home insurance and motor vehicle cover. The Financial Conduct Authority found that there was a persistent sales culture of pushing add-on products to retail customers, such as vehicle recovery cover, accidental injury cover for partners and dependents, and home emergency repair cover. The add-on products were often offered to retail customers with free premiums for a few initial months before additional premiums would become payable. The Group was fined in July 2013 by the Authority for failing to ensure that the add-on products were sold fairly to customers. In November 2014, the Authority took disciplinary action against the Chief Executive Peter Halpin, finance director Anthony Clare and director Nicholas Bowyer as being the person mainly responsible for instituting incentive structures

[70] http://www.fsa.gov.uk/static/pubs/final/peter-cummings.pdf.
[71] http://www.fsa.gov.uk/static/pubs/final/peter-cummings.pdf.
[72] http://fca.org.uk/news/former-swinton-executives-fined-and-banned-misselling.

to promote add-on sales. Peter Halpin was fined in the region of over £400,000 and banned from carrying on significant functions in any other financial institution for failing to ensure that compliance programs such as call monitoring were carried out, and that adequate information on sales practices were passed on to be evaluated by compliance departments. Anthony Clare was fined £206,000 and similarly banned for the failure to ensure adequate compliance oversight of the sales processes while being in the position of having oversight of compliance, risk management and finance. Nicholas Bowyer was fined £306,000 and similarly banned for having instituted the questionable sales incentive schemes and hence being responsible for a culture of unsuitable and predatory sales practices at the firm.

Personal liability for directors and senior management is a formidable strategy in regulating key decision-makers in a financial institution. Chief executives of large financial groups such as UBS and Mitsui Sumitomo have also been subject to enforcement actions. In the Mitsui Sumitomo case, the Chief executive Yohichi Kumagai was fined £100,000 and banned for life from working in the UK financial services industry.[73] The then-FSA alleged that he had failed to institute adequate committees on the Board and to ensure that sufficiently senior persons were responsible for certain high level executive functions. He had also allowed the level of capital adequacy to fall below the threshold level required by regulation. Kumagai had assumed position of Chief executive in 2009 and had taken on responsibility for growing the non-life insurance business in the UK. By 2011, the then-FSA had several meetings with Kumagai to point out deficiencies in the corporate governance of Mitsui Sumitomo and worrying levels of capital adequacy. However, the regulator was ultimately of the view that Kumagai failed to adequately address these issues and appreciate their importance and severity.

In a recent high-profile case,[74] Chief Executive Stewart Ford of Keydata Investment Services was fined £75 million for mis-selling and also issued with a disqualification order. Keydata marketed and sold structured investment products to retail consumers based on assignments of life insurance policies by American retail policy holders who longer wanted to service them. The products were illiquid and high risk in nature as returns would only be realised if the policy-holders died and the insurance companies paid on them. The products were marketed extensively as low risk, and inadequate customer due diligence was undertaken to assess suitability at point of sale. Ford oversaw the misleading marketing of these products and also misled the regulator when interviewed about the compliance and performance of these products. However, the regulator's investigations against Keydata caused Keydata to eventually go into administration, entailing severe losses for retail investors of those products. The regulator's fine was premised on the personal profit made by Ford who ignored conflicts of interest in his sales strategy.

However, in relation to John Pottage, Chief Executive of UBS who was alleged to have also failed to ensure that the business of the firm was organised in a controlled and compliant manner, Pottage referred the then-FSA's decision to the Upper Tribunal[75] and secured a victory overturning the then-FSA's case against him. Pottage assumed position as Chief Executive at a time when he was aware of

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[73] http://www.fsa.gov.uk/static/pubs/final/yohichi-kumagai.pdf.

[74] FCA, *Decision Notice against Stewart Owen Ford* (7 Nov 2014) at https://www.fca.org.uk/static/documents/decision-notices/stewart-owen-ford.pdf.

[75] *John Pottage v FSA* (20 April 2012) at http://www.tribunals.gov.uk/financeandtax/Documents/decisions/John_Pottage_v_FSA_decision.pdf.

risk management and control deficiencies at UBS in terms of: operational risk, implementation of the lines of defence at UBS, inadequate information flows of risk between departments and to the executive level and breaches in the conduct of client money handling. Pottage was of the view that he had instituted an overhaul review, made new appointments and installed systems, and had personal engagement with issues via discussion in frequent meetings. However, the then-FSA alleged that UBS' failings were to be attributed to Pottage's oversight responsibility which was inadequate. The Upper Tribunal agreed with Pottage that he had done sufficiently as was required to address the problems brought to his attention and had instituted reforms in processes and systems. The failure of ground implementation could not fully be attributed to Pottage, and not every defect discovered warranted costly inquiries and overhaul as the then-FSA had expected Pottage to undertake. The then-FSA had also relied excessively on an expert opinion report that pointed out what Pottage ought to have done, and the Tribunal disagreed with many aspects, considering the demands excessive. Pottage was therefore cleared by the Upper Tribunal. The decision in favour of Pottage is however in the minority as the majority of Tribunal decisions upheld the regulator's enforcement.

The enforcement decisions show the determination of the regulatory authorities to carry out the deterrence objective in relation to compelling responsible individuals to take ownership of public interest and regulatory objectives in financial services regulation.. This relatively active area of enforcement arguably poses more of a personal threat to senior management in the financial sector than private litigation in directors' duties, which is rare for public companies in the UK generally,[76] and has been lacking in the financial sector even in the wake of the global financial crisis. The next Section discusses how the Senior Persons Regime may change directorial conduct in financial services and provides reflections on the interface between directors' obligations under financial regulation and company law.

C. The Interface between the Senior Persons Regime and Directors' Duties in Company Law

Bifurcation from Directors' Duties in Company law

This article has so far argued that the Senior Persons Regime for directors in the UK financial services sector creates a bifurcation between directors' obligations under general company law and under specific regulatory law. This is unique as sectoral regulation is usually aimed at firms and not particular personnel. Further, the obligations created under the Senior Persons Regime are also broadly worded and are not merely technical matters for compliance as such. Due to the limitations of company law enforcement against financial institution directors in the aftermath of the global financial crisis, it may be argued that the Senior Persons Regime is a form of substituted governance i.e. regulatory governance stepping in to take the place of general company law in governing directorial conduct. This article prefers to see the Senior Persons Regime as a form of novel regulatory intervention that addresses different purposes from under company law. Directors' duties in company law are for the purposes of accountability to capital providers, ie shareholders and creditors (in the twilight zone of the company), as discussed in Section A. The nature of accountability and responsibility we wish to hold directors to in the financial sector relates much more to the protection of public interest. Policy-makers' intention is to ensure that senior

[76] John Armour, Bernard Black, Brian Cheffins and Richard Nolan, 'Private Enforcement of Company law: An Empirical Comparison of the UK and US' (2009) 6 Journal of Empirical Legal Studies 687.

management of financial sector institutions do not allow firm practices to compromise the unrepresented voices that are interested in the systemic importance of financial institutions and the implications from the proper conduct of financial intermediation. Hence, regulatory duties are able to take into account the wider public interest in the sound running of a financial institution and the standards of conduct expected of these institutions. This is a different regime from directors' duties owed to capital providers, and perhaps rightly so. However, although the article supports the rationale for the Senior Persons Regime, and notes that there is increasing international interest[77] in the UK's pioneering approach, there are a few notes of caution that should be sounded.

Interface between the Two Regimes- The Eclipse of Market-based Governance and Compensation Needs?

The Senior Persons Regime is a regulatory regime that establishes increased direct accountability to regulators, and fosters increased recognition on the part of directors of the public interest in the institutions they are overseeing. It is however not a regime that should encourage the eclipse of market discipline in corporate governance, or be excessively relied upon by the firm's capital providers to monitor agency problems. Such reliance could result in an unhealthy form of moral hazard on the part of capital providers. It is still for capital providers of a firm to determine if they should take civil enforcement actions in order to redress their private interests. Capital providers of financial institutions should not regard themselves as being able to free-ride on regulatory supervision, or relinquish their role in monitoring in view of regulatory supervision. But regulatory enforcement may uncover information that could be helpful for appropriate civil actions. For example, SM3 under the Rules of Conduct for senior persons requires that senior persons oversee any delegation effectively. This obligation to some extent overlaps with the general duty of care in directors' duties (section 174 of the Companies Act 2006).[78] A director liable for breach of SM3 to the regulator may also face an action by the firm or a derivative suit in respect of breach of the duty of care, although such duty must be interpreted by the court in relation to the interests of the company and the members as a whole. Hence, regulatory enforcement actions may uncover information useful for subsequent company law enforcement. In other words, the weaknesses perceived so far in the directors' duties regime in company law are not inherent weaknesses, and enforcement could be helped by the mitigation of information asymmetry that the regulatory processes facilitate.

However, the optimism in theory discussed above may be misplaced. This is because private enforcement may be marginalised if the fines levied under regulatory enforcement exhaust the D&O insurance cover 'pot', or where regulatory enforcement uncovers conduct that may fall outside of the D&O insurance coverage. Regarding the former, we have observed that regulatory fines can be massive and it may be stretching a director's D&O insurance cover to pay out on the regulatory fine. In such cases, there would be a lack of incentive for private enforcement as compensation would seem remote. Practically speaking, due to finite means of recovery, regulatory enforcement can 'squeeze out' private enforcement, and therefore encourage the company and its shareholders to treat regulatory supervision and enforcement as a form of substitution for their monitoring role.

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[77] The US is also stepping up individual scrutiny and accountability, see 'Regulators Intensify Scrutiny of Bank Boards', *The Wall Street Journal* (30 March 2015).

[78] *Re Barings plc (No.5)* [1999] 1 BCLC 433, *Lexi Holdings plc (in admin) v Luqman* [2008] WLR (D) 1, *Weavering Capital (UK) Ltd (in liquidation) and others v Peterson and others* [2012] EWHC 1480 (Ch).

Further, in a case where the regulator takes enforcement action for breaches of rules such as lack of integrity or lack of open-ness in cooperation with the regulation (such as in the allegations against Stewart Ford in the Keydata case discussed above), it is uncertain if such conduct would be regarded as sufficient egregious to fall outside of the scope of D&O insurance cover. In such cases, there would be even greater dis-incentives for private enforcement to take place.

Thus, although this article argues that the regulatory regime and directors' duties regime in company have different objectives and ought to be applied differently, there may be an inevitable practical interface between the two regimes that results in the marginalisation of private enforcement. This could result in a deficit in the compensation needs of the aggrieved company concerned. At the moment the recovery of fines by regulators are not applied partly towards compensation of legitimate grievances that would need to be addressed in private enforcement. This position could be rethought.

The Role of the Breach of Statutory Duty Action

Where regulatory enforcement takes over as the main means of governing directorial responsibility and conduct in the financial services sector and results in a deficit in meeting the compensation needs of potential private litigants, it may be queried whether such private litigants may be able to meet their compensation needs by relying on s150 of the Financial Services and Markets Act which provides a right of civil action in breach of statutory duty?

There are however pros and cons in arguing that s150 applies to private litigants against financial institution directors who have become liable for breach of regulations. Even if this action allows private litigants to ride upon the regulatory enforcement that has taken place to claim compensation, the recovery of compensation still largely depends on whether regulatory fines have exhausted the D&O insurance coverage or whether there is cover for the conduct alleged. However, one may argue that section 150 *should* not apply as this allows capital providers of a financial institution to free-ride upon public interest enforcement where private enforcement may be less likely successful. It may therefore seem rather perverse for capital providers to obtain private compensation for themselves on the back of enforcement against directors for breaches of public interest type duties.

That said, this article is of the view that s150 is unlikely to apply to benefit private litigants against directors subject to regulatory enforcement. First, section 150 applies to firm contraventions of regulatory requirements, and senior persons' contraventions are arguably not within the scope of section 150. Further, section 150 is intended to apply to a private person who suffers loss as a result of firm contravention. For example, a customer who has received unsuitable investment advice and suffers a loss has an interest to take a civil action against the firm, although the firm is also liable to the regulator for regulatory contravention of the requirement of suitability.[79] As shareholder suits against directors are derivative in nature, and there are great limitations to recovering for reflective loss,[80] it is unlikely that shareholders can show 'personal loss' as required under the section.

[79] *Zaki & ors v- Credit Suisse (UK) Limited* [2013] EWCA Civ 14.

[80] *Johnson v Gore Wood* [2001] 2 WLR 72; *Gardner v Parker* [2005] BCC 46; *Malhotra v Malhotra & Anor .* [2014] EWHC 113 (Comm) , see Charles Mitchell, 'Mitchell, 'Shareholders' Claims for Reflective Loss' (2004) L.Q.R. 457; exceptions are strict and relate only to where the shareholder who suffers a personal loss or where

Interface between the Two Regimes- Impact on Director Behaviour

Although the foregoing has pointed out that the regulatory regime has the potential to weaken enforcement under directors' duties in company law, creating an unintended adverse effect, it is questioned whether regulatory supervision and enforcement may provide some positive externalities that mitigate the private enforcement deficit that may arise.

This Section argues that there are likely positive externalities that will result from the regulatory governance of directorial behaviour for directors' duties under company law. First, the strict liability nature of the Senior Persons Regime may introduce certain incentives for directorial behaviour that relates to oversight. The key provision that senior persons would be mindful of is that strict liability is attached to their oversight responsibilities if regulatory contravention relating to one's area of oversight should occur.[81] Although such liability is secondary liability, i.e. that the individual is liable on account of the firm's primary contravention of regulatory requirements, secondary liability usually serves a deterrent purpose in order to motivate the individual to prevent the firm's primary contravention. On the positive side, the threat of strict secondary liability for senior persons may incentivise them to act or make decisions in such a way as to secure effective internal control and regulatory compliance, and in due course cement a healthy compliance culture in the firm. The threat of such liability would also likely incentivise senior persons to devise more robust forms of internal control. Such systems may assist senior persons in information collection, monitoring and reviewing, holding delegates to account and ensuring that control policies and systems are effectively cascaded and implemented throughout the organisation. These initiatives are likely to improve the control culture of the firm generally, even if increased procedures appear to be formalities.[82] Risk and control culture at financial sector firms are an emerging area for development in the wake of the global financial crisis,[83] but are areas which evade regulatory prescription. The Senior Persons Regime, by introducing strict secondary liability for responsible individuals, may be effective in compelling firms to institute systems to govern themselves from the inside out, in order to meet regulatory objectives. In this case, the Regime may achieve a smart form of 'meta-regulation' by motivating the firm itself to use its resources and capacity to align its behaviour with regulatory objectives, culminating in an efficient form of regulatory governance.[84] Positive externalities may be created in terms of directors' duties under company law as directors may take increased care and diligence, and integrate a healthy compliant culture into the overall strategic promotion of success of the company.

Further, it may be argued that as senior persons are subject to clear and prescribed scopes of responsibilities, they would be more mindful of what they are responsible for and would ensure that

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the company has no cause of action, eg see *Rehman v Jones Lang La Salle* [2013] EWHC Civ 1339 (QB); *Giles v Rhind* [2002] EWCA Civ 1428

[81] Sections 66A, 66B, Financial Services and Markets Act 2000 as amended by the Financial Services (Banking Reform) Act 2013.

[82] Christine Parker and Vibeke Lehmann Nielsen, 'Corporate Compliance Systems : Could They Make Any Difference?' (2009) 41 Administration and Society 3.

[83] Erik Banks, *Risk Culture* (Basingstoke: Palgrave Macmillan, 2012); Jonas Prager, 'The Financial Crisis of 2007/8: Misaligned Incentives, Bank Mismanagement, And Troubling Policy Implications' (2012) at http://ssrn.com/abstract=2094662.

[84] Christine Parker, *The Open Corporation* (Cambridge: CUP 2002); "Meta-Regulation: Legal Accountability for Corporate Social Responsibility" (2006) at http://articles.ssrn.com/sol3/articles.cfm?abstract_id=942157; Colin Scott, "Regulating Everything: From Mega- To Meta-Regulation" (2012) 60 Administration 61.

such responsibilities are manageable and managed. This could promote better governability of the firm as a whole. As such, positive externalities can entail in terms of better management that is beneficial for promotion of the success of the company.

However, less beneficial effects in organisational culture such as defensiveness and risk or blame shifting may also occur. This is because it would arguably be improbable that senior persons who have delegated various tasks and responsibilities may be able to institute perfect systems of monitoring and prevention of wrong-doing. Hence, with strict liability in place, senior persons are unsure of the extent to which the regulator could hold them to blame for every imperfection or shortfall- as Pottage's case illustrates. Although the Upper Tribunal in Pottage's case has shown that the Tribunal is willing to accept that a certain extent of personal attention and involvement is sufficiently reasonable and that excessive demands on the part of the regulators would be rejected, what is nevertheless uncertain is the extent of personal endeavour needed for a senior person to have peace of mind.

This article is therefore concerned that such uncertainty may result in risk averse and defensive personal behaviour on the part of senior persons. For example, senior persons may engage in excessively precise and narrow interpretations of their scope of responsibility. As the PRA and FCA envisage that each prescribed senior person responsibility should normally be attached to one individual and not shared,[85] firms may establish more silo[86] and defensive approaches to protect individual liability. Such may be unhealthy for the risk and control culture for the organisation as a whole. Senior persons may also engage in excessive proceduralisation in order to ensure a trail of auditable personal endeavours that may discharge the individual of liability. Inward-looking and defensive pre-occupations may draw attention away from the important tasks of strategically managing the business. Hence, it has to be examined to what extent 'defensive' and compliance concerns for directors may affect their strategic decisions in promoting the success of the company. Directors may become incentivised to take comfortable decisions rather than visionary ones that are riskier in nature, and this could affect the long-term competitiveness of companies.

Further, it is queried whether non-executive directors who are usually tasked to chair committees of the Board such as the Audit or Risk Committees may bear a disproportionate amount of liability for being in that position, albeit in a non-executive capacity. Although the regulators have clarified[87] that non-executive directors do not generally fall within the senior persons regime except for committee Chairs, so as not to disincentivise persons from taking up non-executive appointments in banks and financial institutions, the non-executive Chairs of Board committees could face considerable pressure to manage their personal risks.[88] Although the Regime targets the top in order

[85] Although the onus is on firms to show that shared responsibilities would be appropriately carried out and not leave gaps, see PRA/FCA, *CP15/22 Strengthening Accountability in Banking: Final rules (including feedback on CP14/31 and CP15/5) and consultation on extending the Certification Regime to wholesale market activities* (July 2015).

[86] Criticised in House of Commons and House of Lords, Parliamentary Commission on Banking Standards, *An Accident Waiting to Happen: The Failure of HBOS* (4 April 2013), paras 54-61.

[87] FCA, CP15/5: *Approach to Non-Executive Directors in Banking And Solvency II Firms & Application of the Presumption of Responsibility to Senior Managers In Banking Firms* (23 Feb 2015).

[88] Although the FCA and PRA clarify that non-executive directors can only take up the prescribed responsibilities appropriate for non-executives, see PRA/FCA, *CP15/22 Strengthening Accountability in*

to change tone at the top to motivate grand changes in organisational culture in the financial sector, the large stick looming over the top creates other incentives for mitigating and avoiding personal risk which could adversely affect Board dynamics and senior management culture, and ultimately firm culture.

Further, increased prospect of regulatory liability could affect the design, scope of cover and cost of D&O insurance for directors in the financial sector. The cost of premiums has risen for directors in the financial sector, and scope of cover may not be foolproof.[89] Concerns about sufficiency of cover and certainty of pay-out will further worsen the prospects of private enforcement under company law.

Moreover, the general move towards defensive and compliant behaviour by directors and financial institutions would likely increase the cost of doing business that would be cascaded down towards increasing the cost of financial services. There may even be services that may become less accessible or withdrawn. Hence the impact of the Senior Persons Regime on ultimate social access to finance may need to be weighed up in due course.

In sum, although this article supports the imposition of the Senior Persons Regime for senior management in the financial sector, as the Regime is intended to achieve deterrence objectives relating to public interest and should not be subsumed under the directors' duties regime in company law, the article sounds notes of caution in relation to the Regime's impact on directors' behaviour and wider ramifications.

Enriques et al caution that prescriptive measures and incentive-based regulation that address corporate governance problems that arose in the global financial crisis are likely to entail other unintended adverse consequences. They warn that enhanced directorial liability regimes could result in poor Board dynamics, behaviour that is overly cautious and defensive to avoid personal liability and the tendency to stick to decisions and not adapt them in order to not attract personal liability for 'wrong decisions' with the benefit of hindsight. [90] Rawlings et al also cautioned that enforcement in financial regulation should not make an excessive spectacle of the punished as the deterrence rationale can be lost if the regulated becomes disengaged from a regime of sanctions that they regard as disproportionate, unfair and primitive.[91] Perhaps the regulatory regime, particularly in terms of strict secondary liability, may be adjusted in due course after observations are made as to its outworking.

D. Conclusion

A special Senior Persons Regime has been introduced for senior management at financial institutions in order to impose duties on senior management to take steps to secure regulatory compliance and a sound risk and control culture at firms. This article supports the rationale for the Regime in relation to imposing individual standards on senior persons that are not necessarily applicable to the general

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Banking: Final rules (including feedback on CP14/31 and CP15/5) and consultation on extending the Certification Regime to wholesale market activities (July 2015).

[89] 'Insurance: Directors Take Action against Rising Tide of Litigation', *Financial Times* (29 April 2013).

[90] Luca Enriques and Dirk Zetzsche, 'Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive' (2014) at http://ssrn.com/abstract=2412601.

[91] Philip Rawlings, Andromachi Georgosuli and Costanza Russo, 'Regulation of Financial Services: Aims and Methods' (2014) at http://www.ccls.qmul.ac.uk/docs/research/138683.pdf.

corporate sector. As such individual standards are connected to the public interest in how financial institutions are governed and managed, they are not framed as accountability to capital providers and thus should not be incorporated into directors' duties in company law. This article argues that the regimes in regulation and in company law serve different purposes and each provide a form of governance that is important in their own right. However, given the paucity of enforcement in company law in relation to financial institution directors, the introduction of the regulatory regime may practically further diminish the role of private litigation in company law, although this need not be the case. This article also critically assesses what may be achieved by the imposition of regulatory standards for directors in terms of changing organisational culture and paving the way for more responsible financial intermediation. Moreover, this article cautions that the demands in these standards remain uncertain in terms of the expectations of personal endeavour required on the part of senior persons, and fear of enforcement could entail defensive and risk or blame-shifting behaviour, which would become unhealthy for organisations. It is recommended that the Senior Persons Regime be regarded as an experiment in regulatory methodology, and proportionality in enforcement should be considered seriously. Nevertheless, if the Regime turns out to be convincing and successful, this could become an example for other sectors where the regulation of individuals could be needed to motivate organisational and sectoral change.