

REGULATION OF

*culture in finance*¹

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This paper examines the regulatory reforms that have been introduced internationally in the wake of the global financial crisis and their impact on the culture of financial services firms. It also considers how the introduction of the Banking Executive Accountability Regime (BEAR) is likely to shape Australia's financial services landscape. The paper was delivered at the Monash University and Australian Centre for Financial Studies' 22nd Melbourne Money and Finance Conference on 10 July 2017.

Following the global financial crisis (GFC) and subsequent scandals in the financial services industry, including allegations of LIBOR and FX manipulation in wholesale markets, policy makers have concluded that fines were not a wholly effective deterrent.

Poor corporate culture has been identified as the root cause of many of the issues underpinning the GFC. According to the London School of Economics, between 2008 and 2012 the cost of poor conduct for the 10 most-affected global banks was approximately GBP150 billion.²

Individual accountability has become the new zeitgeist, starting in the Northern Hemisphere. In Australia, these developments have recently coalesced into an announcement in the 2017-18 federal budget of the introduction of the BEAR. Once implemented, it will serve to increase the potential for personal liability of Australia's top banking executives.

While there is limited information currently available it appears that the BEAR is largely modelled on the UK Senior Managers Regime (SMR), which came into effect on 7 March 2016 and marked a shift in regulatory compliance for banks based in the UK and UK branches of foreign banks. The regime, which has been implemented by the UK Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) was designed to ensure the accountability of senior managers whose actions fall below the standards expected in respect of the particular area(s) of the firm's activities for which they are responsible.³ The US took a different approach, favouring issuing directives to Department of Justice (DOJ) employees to specifically focus on individuals when investigating instances of corporate misconduct.

This paper looks at the reforms that have taken place globally, the impact they have had on the culture of financial firms and how the BEAR is likely to shape Australia's financial services landscape.

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United Kingdom

The Parliamentary Commission on Banking Standards was established in June 2012 to consider and make recommendations in relation to the 'professional standards and culture of the UK banking sector'.⁴ It is worth noting that, in the UK, since the GFC, virtually no personal convictions have been made.⁵ In that forum, the former CEO of the FCA, Tracey McDermott, stated that investigators looking into alleged misconduct found that the trail often went cold as they looked at the upper echelons of firms' management. She described an 'accountability firewall' in financial institutions.⁶

Following that statement was another by Martin Wheatley, also a former CEO of the UK FCA, to the UK Treasury Select Committee in September 2013 in which he indicated: 'It has been hard to nail an individual against responsibility because matrix organisations structures, committee decision-making means that individuals always defuse responsibility ... it is not the powers that are lacking, but frankly, evidence is hard to gather in a way that would allow you to take action'.

The Commission's final report was released in June 2013 and led to the introduction of the SMR. It is important to note that the impetus behind the regime came from lawmakers and not regulators.

The SMR, together with the Certification Regime and new Conduct Rules replaces the previous approved persons regime (APR), which involved formal pre-approval of individuals by regulators to undertake certain roles within financial institutions. The key changes from the pre-existing APR are: the population of individuals required to be pre-approved by the regulators has decreased in size significantly (with substantial new obligations on institutions themselves to certify larger populations of individuals as 'fit and proper' under the Certification Regime); and the introduction of a statutory duty of responsibility on senior individuals and some non-executive directors (NEDs) to take reasonable steps to prevent regulatory breaches by the firm in the area(s) for which they are responsible. These areas are required to be set out concisely in documents which are called 'statements of responsibility'. These statements are to be used at the approval, supervision and enforcement stages. The intention is that, if something awry happens on a global banks' trading floor, irrespective of committees, dotted lines and direct involvement, the regulators know who to focus on. The same goes for other divisions (e.g. risk and compliance). Firms are also required to prepare Management Responsibilities Maps providing an overview of governance arrangements within their organisations.

Senior Managers are subject to new Conduct Rules (as are almost all of the other employees in financial services firms), which set out the basic standards of behaviour that are required to be met. For example '[y]ou must act with integrity' and '[y]ou must pay due regard to the interests of customers and treat them fairly'. There are additional rules applicable to Senior Managers only.

As noted above, the SMR has been introduced alongside a Certification Regime requiring firms to certify the fitness and propriety of individuals who could inflict significant harm on the firm or its customers (determined by reference to nine 'significant harm functions', some of which have given rise to intensive debate, particularly in respect of individuals not physically located in the UK).

Finally, changes to regulatory frameworks relating to individual accountability have been accompanied by a new criminal offence, applicable only to Senior Managers, of taking a decision leading to the failure of a financial institution. Although this new offence attracted much fanfare when it was placed on the statute book, it is not likely to be widely used (if at all). Prosecuting authorities would encounter substantial evidential difficulties when seeking to establish that a decision taken by an individual Senior Manager led to the failure of an institution.

There is no territorial limitation on the SMR, so someone who sits in New York and has responsibility for the trading activities of a UK arm will likely be caught. At present, all regulated firms are expected to fall under the SMR regime by 2018.

United States

The US does not have a directly comparable regime to the SMR. Playing to the strengths of its more flexible system, it has largely eschewed wholesale structural reform in favour of realigning investigators' and prosecutors' focus.

On 9 September 2015, the then-Deputy Attorney General Sally Yates issued a memorandum entitled, *Individual Accountability for Corporate Wrongdoing*, otherwise known as the 'Yates Memo'.⁷ Before its release, Yates had foreshadowed her policy intentions and publicly stated that 'by holding individual[s] accountable, we can change corporate culture to appropriately recognise the full costs of wrongdoing, rather than treating liability as the cost of doing business'.⁸

The memo provided guidance to criminal prosecutors and civil enforcement lawyers and set out six steps to ensure corporate investigations were handled consistently across the DOJ. Importantly, two of these guiding principles stated:

- Both criminal and civil DOJ corporate investigations should focus on individuals from the inception of the investigation.
- To be eligible for any cooperation credit, corporations must provide to the DOJ all relevant facts about the individuals involved in the corporate misconduct.

The US approach does not introduce new laws designed to increase individual liability. Instead, policy makers are working within an existing structural framework.

Hong Kong/Singapore

On 16 December 2016, the Securities and Futures Commission (SFC) announced it was taking steps to enhance the senior management regime of licensed corporations. These requirements seek to promote senior individuals' awareness of their regulatory obligations and accountability for misconduct that falls within their area of responsibility. There are a number of similarities to the SMR, although the regime is not targeted at banks. There is a requirement to provide information as to 'managers in charge' and organisational charts to the SFC.

The *Banking Amendment Bill 2016* was passed by the Singapore Parliament on 29 February 2016 to strengthen the Monetary Authority of Singapore's (MAS) oversight over banks' risk management controls. The Bill reflects the MAS' increased focus on individual accountability and includes widened powers of the MAS to remove directors and executive officers of banks on the basis that they are not 'fit and proper' (among others). On 9 January 2017, the MAS announced the second reading of the Bill in the Singaporean Parliament, with the amendments yet to take effect.

Separately, the MAS issued a consultation paper in February 2017, which proposes new banking regulations in relation to risk management controls. As to individual accountability, the proposed new regulations require banks to specify the roles and responsibilities of officers and employees of the bank to ensure its compliance with laws and regulations, codes of conduct and standards of good practice. Notably, the proposed new regulations do not go as far as the UK SMR and the HK regime, in that they do not require specific individuals to be identified/named. The industry in Singapore is speculating as to why the Banking Amendment Bill has not yet become law, despite being passed by the Parliament in early 2016. It is likely that the MAS is firming up subsidiary regulations and guidelines in relation to the new amendments, by reference to the consultation paper, before implementing them into law.

Impact on culture in finance to date

The full impact of the introduction of the SMR and the other enhancements to regulatory frameworks relating to individual accountability in the UK remains to be seen. There have not yet been any concluded enforcement actions against Senior Managers, although we are aware that there are at least two ongoing enforcement investigations looking at the role of individual Senior Managers in regulatory breaches by firms. The message emerging from the UK regulators is that it is not the purpose of the regime to drive up the number of enforcement cases, but rather to encourage changes to behaviours obviating the need for such action in the first place. In the course of acting for numerous institutions in connection with the implementation of the regimes, we have observed noticeable changes in the ways in which governance arrangements

are structured and responsibilities are assigned between senior executives, as well as the ways in which key day-to-day processes such as delegation and decision making are undertaken. Institutions and individuals have been required to ask difficult questions of themselves and re-evaluate heavily entrenched structures, practices and arrangements.

By contrast, in the US, the Yates Memo may prove to be a case of, 'the more things change, the more they stay the same'. Notwithstanding that the then-Deputy Yates described the memo as a 'substantial shift' in Department policy, many practitioners believe that the level of candour that the Yates Memo demanded were well-enshrined in the Department's federal prosecution policy. The DOJ's pursuit of the LIBOR and FX criminal investigations against a plethora of large financial institutions as well as criminal prosecutions of individual employees evidences this in practice. These cases preceded the Yates Memo by a number of years. There also remains a concern that the Yates Memo has made company-level cooperation more challenging, time consuming and expensive. This is particularly relevant to companies conducting their own internal investigations and finding that their employees are unwilling to provide needed detail, for fear that they are exposing themselves to individual liability. Nevertheless, it remains to be seen how, if at all, the new US presidential administration and the corresponding change in leadership at the DOJ will affect the Department's focus on individual wrongdoing.

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Australia: Pre-BEAR

ASIC's focus on the risks associated with culture was made clear in its 2014-2015 Strategic Outlook. It identified corporate culture as a key risk driver and potential root cause of conduct threatening the integrity of financial services regime.

Since then, key statements made by ASIC's Chair Greg Medcraft have included that he has 'constantly been disappointed' at the 'gap in culture or ethics in the banks in the past few years' and 'culture is not something that can be regulated by black-letter laws'. The latter statement is in line with earlier statements made by the Chair pushing back against the SMR, including in November 2015 when he stated (emphasis added):

While I do believe that holding senior managers and key staff accountable is important to culture, *I don't think we want, or need, to micromanage in the way the UK regime does ...*

Media statements aside, ASIC has incorporated culture into its risk-based surveillance reviews. A comprehensive guide has been prepared for its surveillance teams, which includes 'positive and negative indicators of culture, documents to ask for and questions to ask'. ASIC has also tested the limits of directors' duties under the *Corporations Act 2001* (Act) in the litigation it has conducted. One such case is the September 2016 decision of *Australian Securities and Investments Commission v Cassimatis (No 8)* [2016] FCA 1023 relating to Storm Financial in which ASIC argued that section 180 of the Act⁹ creates an independent public duty requiring consideration of a 'general norm of conduct' which is not limited to the interests of the corporation; it is a duty which requires consideration of the public interest. Justice Edelman (who has since been appointed to the High Court of Australia) explored this topic, however, did not consider it necessary to decide at that juncture.

APRA has also been focused on corporate culture, with its Chair Wayne Byres stating that failings in culture were one reason underpinning the GFC. Its main contribution to date is prudential standard CPS 220 introduced in January 2015, which requires a bank's board to 'form a view of the risk culture in the institution, and the extent to which that culture supports the ability of the institution to operate consistently within its risk appetite'. It requires the board to ensure: 'a sound risk management culture is established and maintained throughout the institution'.

Two recent Parliamentary inquiries of the House of Representatives Economics Committee have explored culture in financial services: the first in October 2016 and the second in March 2017. Both inquiries questioned the CEOs of major Australian banks on measures to improve corporate culture within the financial sector as well as the imposition of a SMR.¹⁰ At the October 2016 hearing, two of the four main bank CEOs voiced tentative support for the SMR. Greg Medcraft repeated his view that the SMR was micromanagement and stated that, while it seemed to be going well in the UK, it was premature to judge whether it was a success or not.¹¹ Conversely, Wayne Byres backed the introduction of a regime akin to the SMR where details of roles and responsibilities of managers are provided to regulators to enhance accountability.¹²

In November 2016, the Committee released a report titled 'Review of the Four Major Banks (First Report)'. A key recommendation emanating from that report was that ASIC would require Australian Financial Service License holders, which extend far beyond banks, to publicly report any significant breaches of licence obligations within five business days of reporting the incident to ASIC, including a description of the breach, how it occurred, steps taken to ensure it will not occur again, the names of the senior executives responsible for the teams where the breach occurred and consequences for those senior executives.

In the March 2017 hearing, the Committee received feedback on the recommendation to 'name and shame' senior executives for breaches. Only one major bank CEO appeared to voice some qualified approval, with other CEOs objecting to the timeframes, potential misinformation and that it could act as a disincentive to report breaches.

The BEAR

On 9 May 2017, the federal government outlined its budget agenda. This included proposed reforms to introduce a BEAR for all authorised deposit-taking institutions (ADIs).¹³

The key elements of the BEAR largely mirror the SMR, and include:

- > a requirement that all senior executives and directors will register with APRA (the choice of the term 'register' suggests a lower requirement than the UK regime which extends to regulatory approval of senior executives)
- > a requirement that all ADIs prepare accountability maps identifying the roles and responsibilities of their senior executives
- > stronger powers for APRA to remove and disqualify senior executives and directors of all APRA regulated institutions, not just ADIs. APRA decisions will be reviewable by the Administrative Appeals Tribunal
- > the introduction of new principles-based misconduct rules, akin to the UK regime, setting out how ADIs and their executives/directors conduct their business with integrity, due skill, care, diligence and acting in a prudent matter
- > the introduction of a new civil penalty regime, with maximum penalties of \$200 million for larger ADIs and \$50 million for smaller ADIs
- > deferred senior executive remuneration, with at least 40 per cent of the variable remuneration of senior executives to be deferred for at least four years (in the case of CEOs that percentage will increase to 60 per cent)
- > APRA intervention powers to require ADIs to review and adjust their remuneration policies when it believes such policies are not appropriate.

What happens next?

As with the UK SMR, the devil will be in the detail in the new regime. As yet, there is no clear indication as to when further details will be released, but as the government has the benefit of the UK blueprint, it is unlikely the horizon will be long. In any event, the implications of the BEAR on the Australian regulatory landscape for financial services are likely to be significant.

Based on the overseas experience, some changes that we anticipate include:

- > Banking executives will be concerned about the practical, day-to-day requirements of an expected statutory duty to take 'reasonable steps' to prevent regulatory breaches in their area of control. What will this encapsulate and how will they need to modify their behaviour and practices (if at all) to ensure compliance? This will be of particular concern given the likely breadth of the conduct rules. Executives can expect guidelines to be issued by APRA, which will be broadly defined to provide it with a sufficiently strong enforcement mandate.
- > Internal training regimes will be implemented for banking senior managers, as well as policy and procedure guidelines and rules concerning decision making and record-keeping.
- > Significant review, and perhaps overhaul, will occur in terms of current internal governance arrangements within banks in relation to senior executives' roles and responsibilities. The extent of any 'no-gaps' approach applied internally will largely depend on the definition of a senior manager adopted under the BEAR regime.

Conclusion

We are witnessing international reforms focused on heightening senior management responsibility with a view to bringing about cultural change in financial institutions where people take ownership and responsibility for 'doing the right thing' and ensuring 'good outcomes for customers'. The implementation of these reforms remains at an early stage and only time will tell if the proposed measures ultimately close the gap between desired values and actual conduct.

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Addendum

On 13 July 2017, the Treasury released its consultation paper on the BEAR. The closing date for submissions was 3 August 2017. Please contact the authors if you would like a copy of Clifford Chance's submission.

Although relatively brief, the paper provides some additional detail to that announced in the Budget papers, including as to the expectations for ADIs and individuals. As we foreshadowed, the proposed expectations are broad and based on some of the key expectations under the SMR, including (critically) that an 'accountable person' captured under the BEAR would be expected to:

... take reasonable steps to ensure that: the activities of the ADI for which they are responsible are controlled effectively; the activities or business of the ADI for which they are responsible comply with the relevant regulatory requirements and standards ...

Naturally, how such expectations, among others, translate into practice will be the subject of some concern for executives.

Other details revealed include: a focus on legal entities (including ADI subsidiaries not regulated by APRA); an outline of 12 proposed prescribed accountable person functions (for example, Chair of the Risk Committee and C-suite executives) in addition to individuals who otherwise may have significant influence over conduct and behaviour; a proposal to have minimum (as yet unspecified) prescribed responsibilities for accountable persons to assist the accountability mapping mechanism; and a proposal for APRA to be able to disqualify a person without having to apply to the Federal Court and also to permit APRA to seek civil penalties against ADIs, including where they fail to hold accountable persons to account under the BEAR or to appropriately monitor their suitability. Mostly, these details find their precedent in the SMR.

This paper affirms our expectations as to the likely direction the BEAR will take, though there are many outstanding details. Further, some additional questions are raised by the paper, including the statement that the BEAR will apply where there is 'poor conduct that is of a systemic and prudential nature'. When is this apparent conditionality engaged?

For now, we consider that ADIs have sufficient information to begin planning their implementation of the BEAR. From our experience with the SMR and other like regimes, early engagement with executives will pay dividends in the future.

Notes

1. The views expressed in this paper are the authors' own and should not be taken as representation of the views of Clifford Chance. This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.
2. McCormick, R 2013, '[£150 billion in five years – new league table throws new light on cost of banking misconduct](#)', London School of Economics and Political Science, November.
3. Financial Conduct Authority 2015, [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](#).
4. UK Parliament 2012, [Parliamentary Commission on Banking Standards Appointed](#).
5. See, for example, Ford, C 2010, 'Principles-based securities in the wake of the global financial crisis', *McGill Law Journal*, vol. 552, p. 257, p. 288; O'Brien, J, Gilligan, G and Miller, S 2014, 'Culture and the future of financial regulation: How to embed restraint in the interests of systemic stability', *Law and Financial Markets Review*, vol. 8, p. 115, p. 120.
6. UK Parliament 2016, [Changing Banking for Good, Parliamentary Commission on Banking Standards: Sanctions and Enforcement](#), October.
7. Yates, S 2015, [Memorandum for Attorney General – Department of Justice, Individual Liability in Matters of Corporate Wrongdoing](#).
8. Yates, S 2015, remarks at New York University School of Law announcing new policy on 'Individual Liability in Matters of Corporate Wrongdoing', speech delivered at the NYU Program on Corporate Compliance and Enforcement, New York University, 10 September.
9. A director must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise.
10. See Parliament of Australia 2016, [Public Hearings: Past Public Hearings and Transcripts](#).
11. Ibid.
12. Ibid.
13. The 'name and shame' recommendation appears to have disappeared into the ether.