IN BRIEF

- New senior manager rules: three key requirements & removal of the reverse burden of proof.

A change of heart

Bianca Venkata heralds the coming into force of the new senior management regime

On 7 March 2016 the new senior management regime (the regime) will come into force. The regime introduces three key requirements which aim to hold senior managers to account. On 15 October 2015 HM Treasury announced that it was removing the controversial "reverse burden of proof" from the regime. This is despite the fact that the reverse burden of proof was strongly recommended by the Parliamentary Commission on Banking Standards (PCBS) and supported by the government, Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

This article considers three key requirements of the regime and the impact of the removal of the reverse burden of proof.

Background

The financial crisis in 2008 fundamentally changed the perception of the financial sector. The global credit crunch resulted in the near collapse of the banking system. The government invested £37bn to bail out Royal Bank of Scotland, Lloyds TSB, and HBOS. In December 2008, the FTSE 100 closed down by 31.3%, the biggest annual fall in the FTSE's history. A month later, interest rates were cut to a record low of 1.5%. The UK entered a long period of recession. People asked themselves how could such a crisis have occurred? Many blamed the financial services industry. The general outcry led to the setting up of the PCBS. In June 2013, the PCBS published its report, *Changing Banking for Good*.

The PCBS concluded that: "Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making."

The PCBS criticised the approved person regime (APR), the then regulatory regime in the Financial Services and Markets Act 2000 (FSMA 2000). The APR required that certain activities, known as "controlled functions", be performed by "authorised persons". The PCBS found that: "The [APR] has created a largely illusory impression of regulatory control over individuals, while meaningful responsibilities were not in practice attributed to anyone. As a result, there was little realistic prospect of effective enforcement action, even in many of the most flagrant cases of failure."

The PCBS recommended the creation of the regime (as well as a licensing regime and a new single set of conduct rules). The PCBS advised that the key responsibilities within a bank be assigned to a fully accountable senior manager. The PCBS's recommendations were implemented by the Financial Services (Banking Reform) Act 2013 (FS(BR)A 2013) which received Royal Assent on 18 December 2013. The FCA and the PRA published detailed rules regarding the regime in July 2015, *CP 15/22 Strengthening accountability in banking: Final rules* (final rules).

The PCBS also recommended introducing:

- A reverse burden of proof in the regulatory sanction facing senior managers where a firm failed in an area for which they had responsibility; and
- A criminal offence punishable by a custodial sentence for senior managers who performed their functions in a reckless manner.

Three key requirements

FS(BR)A 2013 and the final rules introduce three key requirements for firms:

- First: allocate 17 senior management functions (SMFs), and a person with overall responsibility for the business, to specific senior individuals within the firm. The SMFs include the function of SMF1 Chief Executive, SMF2 Chief Finance and SMF3 Executive Director.
- Second: allocate five prescribed responsibilities to senior mangers. Additional responsibilities apply to larger and smaller firms. The prescribed responsibilities include responsibility for the firm's obligations under the regime and the firm's policies and procedures for countering the risk of being used to further financial crime.
- Third: produce an individual statement of responsibility for each senior manager (stating their SMF and prescribed responsibility) and a responsibilities' map for the firm providing an overview (ideally in one document) of the allocation of the firm's SMFs and prescribed responsibilities.

Reverse burden of proof

The PCBS recommended introducing a reverse burden of proof where a firm committed a breach in an area for which a senior manager had a prescribed responsibility. In such a case, the senior manager had the burden of proof in showing that they took reasonable steps to prevent the breach occurring. Otherwise, the senior manager faced an unlimited fine and the risk of being banned from the profession.

One would be forgiven for thinking that the reverse burden of proof placed unjustifiably difficult demands on senior managers. Indeed the PRA, whilst supporting the policy, emphasised the importance of respecting human rights. The PRA stated in its October 2013 response to the PCBA: "The government has indicated

that senior persons will be subject under FSMA 2000 to a 'reverse burden of proof'. This means they will be subject to disciplinary action if a contravention occurs in their area of responsibility and they did not take reasonable steps to prevent it, or to stop it continuing…The use of remedial requirements or enforcement action must reinforce the deterrent effect of the new regime without encroaching upon human rights."

The FCA more overtly welcomed the introduction of the reverse burden of proof. The FCA stated in its October 2013 response to the PCBS's recommendations: "We agree with the alternative proposal, which would, in effect, place a presumption of responsibility on senior persons when misconduct has occurred…We believe that placing this presumption of responsibility on the relevant individuals will enhance our ability to take enforcement action."

Importantly, the government accepted the PCBS's recommendation. The government implemented the reverse burden of proof in s 32 of FS(BR)A 2013. This inserted ss 66A(6) and 66B(6) of FSMA 2000 which state: "But a person (P) is not guilty of misconduct by virtue of subsection (5) if P satisfies the FCA [or PRA] that P had taken such steps as a person in P's position could reasonably be expected to take to avoid the contravention occurring (or continuing)."

Change of policy

It was widely expected that the reverse burden of proof would be implemented along with the regime in March 2016. The government, PRA and FCA supported the reverse burden of proof. FS(BR)A 2013 had been debated in parliament and given Royal Assent.

Yet, on 15 October 2015 HM Treasury announced it was abolishing the "reverse burden of proof". The Treasury stated: "The government will amend the provisions so that *the regulators will only be able to take action if they can show* that the individual failed to take the steps that it is reasonable for a person in that position to take to prevent a regulatory breach from occurring..." [emphasis added].

At the same time, the Treasury announced that the regime would be extended to all financial services firms, and not just to banks, by 2018. The Treasury appeared to be using the extension of the regime as a reason for removing the reverse burden of proof. The Treasury explained that "the vast majority of the firms that will be brought into the extended regime are much smaller than banks and have significantly less complex hierarchies. It would therefore be *disproportionate to apply the reverse burden of proof* to these firms…" [emphasis added].

The FCA and PRA both gave a careful response to the removal of the reverse burden of proof. Andrew Bailey, head of the PRA stated that "this change is one of process, not substance". Tracey McDermott, chief executive of the FCA commented: "While the presumption of responsibility could have been helpful, it was never a panacea. There has been significant industry focus on this one small element of the reforms, which risked distracting senior management within firms from implementing the letter and spirit of the regime."

Comment

The removal of the reverse burden of proof has been widely welcomed. The reverse burden of proof gave rise to significant criticism: it would discourage talented individuals from taking on senior roles in firms, lead to banks leaving the UK and was contrary to human rights principles. However, some commentators have said that the government's change of policy is a reflection of the powerful lobbying of banks and their clever lawyers. These arguments call for closer examination.

Regarding the potential loss of talent, arguably while remuneration remains high it is unlikely that the reverse burden of proof would discourage ambitious individuals from pursuing senior posts in firms. Nor is the reverse burden of proof likely to lead to a mass exodus of the banks: London has been a historical financial centre for centuries and it arguably requires much more than a reverse burden of proof (such as stricter capital controls) to cause banks to abandon the square mile.

In relation to human rights, it is notable that the reverse burden of proof applied only to the regulatory measure and not the criminal offence. It is worth noting that the PCBS's recommendation for a criminal offence, implemented in s 36 of FS(BR)A 2013, incorporates the usual criminal burden of proof: that the senior manager beyond all reasonable doubt took a reckless decision which caused the firm to fail. The sanctions are an unlimited fine and a potential seven year custodial sentence, section 36(4)(b) of FS(BR)A 2013. While at first glance this seems like a draconian measure, on closer examination, the difficulties in establishing that a single individual decision caused a firm to fail and the high burden of proof (beyond all reasonable doubt) may render the measure rather toothless. The House of Lords in *Sheldrake v DPP* [2004] UKHL 43, [2005] 1 All ER 237 held that a reverse burden of proof, even in a criminal context, is not of itself incompatible with Art 6(2) European Convention on Human Rights. This suggests that the reverse burden of proof in the regulatory sanction was most unlikely to violate human rights law.

Conclusion

The benefits of the regime's three key requirements are likely to be increased transparency and accountability of decision-making in firms. The disadvantage is that the emphasis on individual accountability may undermine collective decision-making. On balance, the removal of the reverse burden of proof is to be welcomed, in the name of fairness and pragmatism. Otherwise disproportionate resources risk being spent on ensuring senior managers make a "reasonable" decision. That would surely be inimical to the development of an effective financial system. It should not be assumed that the removal of the reverse burden of proof leaves the regime without punitive measures. The prospect of criminal sanctions remain, as does the "normal" burden regulatory sanction. Only time will tell the full impact the regime has on individuals and firms alike. **NLJ**

Bianca Venkata, barrister, Outer Temple Chambers (*bianca.venkata@outertemple.com; www.outertemple.com*)