Feature

KEY POINTS

- The newly enacted regulatory regime aims to address concerns of the Parliamentary Commission on Banking Standards about individual responsibility for decision making in banks.
- There have been calls further to curtail socially excessive risk-taking by reforming the duty upon directors, in s 172(1) Companies Act 2006, to promote the success of the company in the interests of its members.
- But given the scope and purpose of the new regulatory regime and the nature of the directors' fiduciary duty, any such reform should be approached with caution.

Author Henry Warwick

For whom should bank directors promote the success of the bank?

The Parliamentary Commission on Banking Standards (PCBS) recommended that banks have to be changed for good. As the new Financial Services (Banking Reform) Act 2013 receives Royal Assent and the FCA and PRA gear up to revise the regulatory regime for senior management in banks, is a further review of the duties owed by directors of banks necessary?

BANKING REFORM AND SENIOR MANAGEMENT

Part 4 of the Financial Services (Banking Reform) Act 2013, which received Royal Assent on 18 December 2013, will implement many of the recommendations for the regulation of senior management in banks made by the PCBS in their Final Report of June 2013 (Changing Banking for Good: Report of the Parliamentary Commission on Banking Standards, HC 175-II).

It is to come into force on a date yet to be appointed. When it does, it will introduce a new regulatory regime for what the PCBS regarded as "senior persons" in banks, by amending the existing approved persons regime in Ch 2 of Pt 10 of the Financial Services and Markets Act 2000 (FSMA 2000). It will repeal aspects of the regime relating to "significant influence functions".

The subjects of the new regime will be senior individuals within authorised persons who exercise a "senior management function". Those functions are given broad definition (set out in a new s 59ZA FSMA 2000), potentially encompassing a wide class of senior management roles.

A function is a "senior management function" in relation to carrying on a regulated activity if:

- the function will require the person performing it to be responsible for managing one or more aspects of the authorised person's affairs, relating to the regulated activity (including taking decisions, or participating in the taking of decisions); and
- those aspects involve, or might involve, "a risk of serious consequences" either (i) for the authorised person, or (ii) "for business or other interests in the United Kingdom".

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REQUIREMENT FOR APPROVAL

Naturally, senior management exercising such functions will require FCA or PRA approval. But applications for such approval will need to contain or be accompanied by a "statement of responsibilities". This will set out the aspects of the affairs of the authorised person that the senior person will be responsible for. There is an ongoing obligation upon the authorised person to revise it, following grant of approval, where there is any significant change to those affairs (by amendment to s 60 FSMA 2000 and a new s 62A).

A further requirement is to be imposed upon the authorised person to vet candidates as fit and proper to perform those functions and to consider, at least annually, whether there are grounds for withdrawing approval and report any such grounds to the FCA or PRA (ss 60A and 63(2)A FSMA 2000 to be inserted).

Both regulators will have broad powers. In addition to the power to withdraw approval of a senior person, they may impose conditions or a time limitation upon approval. Where considered desirable to advance any of that regulator's objectives, they may impose or vary conditions after grant (under a new s 63ZB FSMA 2000), subject to a statutory procedure.

CONDUCT AND DISCIPLINE

FCA and PRA codes of conduct, to which senior persons will be subject, will be published along with statements of policy in relation to approval conditions. The detail of that code remains to be seen. The FCA has indicated it intends to consult on the new regime this year.

But the regulators will have powers to discipline those responsible for senior management functions with reference to an expanded definition of "misconduct" for the purposes of s 66 FSMA 2000. Limitation will be extended to six years.

A senior person, in particular, will be guilty of misconduct if (by a new s 66A(5) and s 66B(5)):

- there has been, or has continued to

be, a contravention of FSMA 2000 (or certain EU provisions, if designated); and

- the senior person was responsible for management of any of the authorised person's activities in relation to which the contravention occurred.

By this means, the new regime will impose direct responsibility for regulatory breaches upon the individual concerned, to the extent any such breach falls within the defined ambit of their role, which will be set out in their statement of responsibilities.

It will be a defence that the senior person had taken such steps as a person in their position could reasonably be expected to take to avoid the contravention, but the burden of proof apparently falls upon the senior person in question to satisfy the FCA/PRA of this.

The revised disciplinary regime will sit alongside the existing right of action for contravention of s 59 FSMA 2000, and a new offence, which has attracted wide publicity and comment, relating to decisions by senior persons that cause a financial institution to fail.

DO THE REFORMS GO FAR ENOUGH?

This new regime will form part of what the PCBS regarded as the "three new pillars" of regulatory reform (see Final Report §612 to §657). The PCBS was particularly concerned:

- to ensure that key responsibilities are assigned to specific individuals who are aware of those responsibilities and have accepted them (§616);
- to narrow the range of individuals from those in "significant influence functions"focusing much more on "people who really run banks and should stand and fall by their role in decision making" (§617);
- to assign all key activities that the business undertakes or risks to which it is potentially exposed to a senior person, aligned with the realities of power and influence (§618);
- to empower regulators to review the assignment of such responsibilities and impose conditions (§626).

But there are those who will argue that these changes do not go far enough and represent a missed opportunity to reform banking regulation. Professors Black and Kershaw argued, in response to the PCBS final report, that banks benefiting from the "too-big-to-fail" subsidy by deposit insurance or informal guarantees, are not adequately disciplined by creditors and have strong incentives to take socially excessive risks (Black and Kershaw: "The Commission on Banking Standards Report and Bank Incentives: A Missed Opportunity", LSE 17.9.13).

In their view, there is a need to consider whether directors of regulated financial institutions, or a sub-sector of them, should be required to give equal weighting to the interests of all corporate constituencies when they act. It is said, with reference to empirical study, the imperative is the need to prevent shareholders (particularly those with limited liability) from contributing to excessive risk-taking, by putting pressure on management to alter the risk profile of bank investments.

The PCBS expressed similar concerns. It cited evidence before it that the implicit taxpayer guarantee provided to limited liability creditors, creates incentives for banks to increase leverage, while fragmentation in the pattern of UK shareholding, including outsourcing to fund managers, has given rise to short-termism and disengagement from the responsibilities of share ownership (§173-176 and §660-666, PCBS Final Report).

The PCBS was concerned that despite share capital forming a relatively small proportion of the funding of banks (such funding being predominately from bondholders, depositors and wholesale money markets), the legal responsibilities of the board of directors of a bank are the same as those of a non-financial company. They too are bound by the fiduciary duty to promote the success of the company for the benefit of its members, set out in s 172 of the Companies Act 2006 (CA 2006) (§667-674 PCBS Final Report).

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PROPOSALS FOR FURTHER REFORM: FIDUCIARY DUTY TO PROMOTE THE SUCCESS OF THE COMPANY

The need to address this particular concern was identified as one of four basic principles by which proposals for change should be assessed. Ultimately, the PCBS recommended only that the government consult upon a proposal to amend s 172 to "...remove shareholder primacy in respect of banks, requiring directors of banks to ensure financial safety and soundness of the company ahead of the interests of its members" (§708, PCBS Final Report).

Black/Kershaw would support a change in corporate purpose and call for consideration to be given to giving equal weight to all corporate constituencies, arguing this should be supported by three-year tenures for directors of ring-fenced banks and a requirement that directors can only be removed during that three-year term at an AGM by majority vote of the issued shares. They cite existing shareholder rights as, in effect, a contributing risk factor.

In its current form, s 172 of CA 2006 sets out a duty which, in common with the other duties described in Ch 2 of Pt 10 of that Act, is based upon, and is in place of, the common law rules and equitable principles applicable in relation to directors (s 170(3), CA 2006). The duty is owed to the company and is to act in

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a way that a director "considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole". The common law considered it a primary duty.

When discharging this duty, directors must to have regard "amongst other matters" to:

> "(a) the likely consequences of any decision in the long term;
> (b) the interests of the company's employees;
> (c) the need to foster the company's business relationships with suppliers, customers and others;
> (d) the impact of the company's operations on the community and the environment;
> (e) the desirability of the company maintaining a reputation for high standards of business conduct; and
> (f) the need to act fairly as between members of the company."

Company Law Review Steering Group (Final Report, Ch 3). Nevertheless, removing any express requirement in the case of banks to act for the benefit of members might allow the common law, hitherto regarded as dynamic in this respect, to set the limits of a board's discretion to favour other considerations in a deposit-taking institution. The statutory requirement as to how the duty is to be interpreted and applied in s 170(4), CA 2006 might accommodate that approach.

At present promoting wider interests other than those contemplated in s 172 would cut across the primary duty (*R on the application of People and Planet v HM Treasury* [2009] EWHC 3020 (Admin)). But the considerations to which directors are obliged to have regard in ss 172(1)(a)-(f) already include the likely consequences of their decisions in the long term, which may allow the courts scope to address the key concerns of the PCBS in this regard.

On the other hand, expressly elevating the interests of bondholders, other creditors or wider stakeholders by requiring that equal regard be given to them would amount to a more radical departure from the principles upon which s 172(1) of CA 2006 was founded.

At common law, directors could only actively promote the interests of groups or entities other than shareholders in limited circumstances. These included where doing so ultimately advanced the interests of shareholders (eg, *Parke v Daily News Ltd* [1962] Ch 927 at 954, 960-961 and *Charterbridge Corporation Ltd v. Lloyds Bank Ltd* [1970] Ch 62 at 74).

The fiduciary duty codified by s 172(1) is owed by directors to the company itself, and, unlike the duty to exercise reasonable care, skill and diligence in s 174, is enforceable as a fiduciary duty (s 178(2)). Given this, it is hard to foresee how (unless the bank is insolvent or on the verge of insolvency, situations that are accommodated by s 172(3)), a duty of that legal nature might properly be discharged by acting for the benefit of creditors, where that is to the detriment of shareholders. A duty, so described, would be inconsistent with the nature of a fiduciary relationship, the distinguishing feature of which is an obligation of single-minded loyalty.

There is also a need to consider the scope and purpose of the fiduciary duty directors would owe alongside the requirements and objectives of the new FSMA 2000 regulatory regime. A class of individuals responsible for senior management, of which all directors would form part, will be within the scope of the new regulatory regime and will be liable to disciplinary action in discharging those functions.

It is said that the fiduciary duty in s 172(1) is an overarching obligation that can easily and properly coexist with other limitations on powers (*Eclairs Group Ltd v. JKX Oil & Gas Plc* [2013] EWHC 2631 (Ch) at §207-§210, regarding the power under s 42, CA 2006). It coexists with the other duties in ss 171-177, CA 2006, which apply cumulatively.

But the definition of "senior management function" suggests that the new regime, and the code of conduct that will form part of it, will at least in part regulate the taking of decisions that carry "a risk of serious consequences...for business or other interests in the United Kingdom".

That is a potentially unlimited category of UK interests. In the context of a bank, such decisions will most obviously include those that may have serious consequences for depositors and bondholders. So it appears likely that directors will already be subject to a regulatory regime that has regard to the overall effect of their decisions on broader business interests.

Given that, and the limited scope there is to require a director, acting as a fiduciary, directly to further interests other than those of the shareholders, there will be those who take the view that any substantial reform to this core aspect of company law would be unnecessary. ■

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OBSERVATIONS

The form any such amendment should take was expressed only in the broadest terms by the PCBS, no doubt to allow a broad range of approaches to be considered.

The general duties owed by directors were the subject of widespread consultation and a great deal of scrutiny prior to their codification in CA 2006. This included the large scale reviews carried out by the Law Commissions and by the Company Law Review Steering Group (Modern Company Law for a Competitive Economy, Final Report July 2001 (URN 01/942)). The approach adopted has been described as representing "enlightened shareholder value": shareholder primacy is preserved while directors are required to have regard to wider implications.

The need for clarity in any formulation of such duties was emphasised by the