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Following the financial crisis of 2008 and the global recession, the world has turned its attention towards banks and those responsible for directing them. A range of problems, including misconduct and adverse publicity (such as LIBOR manipulation and the collapse of banks including African Bank in South Africa) have led governments and regulatory agencies to increasingly focus on finding ways to hold banks and their directors to account. The question is, to what extent and how best to achieve these aims?

A consideration of the laws and policies of the UK and South Africa suggests that there is no real consensus as to the form of liability that should be imposed on bank directors and management. However, this article explains how the authorities in the United Kingdom appear to be exploring criminal liability as a potential method of addressing the perceived issues while the authorities in South Africa are taking an approach more focused on civil law.

THE UNITED KINGDOM

In 2013, after extensive political pressure in the wake of the 2008 financial crisis and later investigations into the manipulation of LIBOR and other benchmarks, the UK government introduced a number of reforms to the manner in which financial institutions (and individuals working in them) were regulated. A key element of this involved the empowerment of the two UK financial services regulators, the Financial Conduct Authority (“FCA”) and the Prudential Regulatory Authority (“PRA”), to regulate the conduct and prudential standards of banks. The FCA and the PRA set out their proposals to address the perceived weaknesses in regulation in a joint paper in summer 2014. This new regime marks a shift in focus towards the personal responsibility and accountability of individuals within financial institutions.

The proposed offences are not presently in force and indications from the government on when (or indeed if) they will ever become active are unclear. However, the fact that they have been included on the statute book gives a clear feel for the direction of travel that regulators in the United Kingdom will take when approaching these issues. Two new offences aim to extend the scope of liability for senior managers in both their supervisory and decision making roles[1]:

1. Criminal liability for causing a financial institution to fail; and
2. Strict Liability for Senior Managers for regulatory misconduct of staff.
1. Criminal liability for causing a financial institution to fail

This new criminal offence essentially enables regulators to prosecute senior managers for reckless misconduct that results in the failure of a financial institution. Under section 36 of the UK Financial Services (Banking Reform) Act 2013, it is a criminal offence for a senior manager in a financial institution to make a decision that causes that institution, or any other financial institution which is a member of the same group, to fail. In order for a successful prosecution it would be necessary to show:

The senior manager takes a decision as to the way in which the business of a financial institution is to be carried on, or fails to take steps to prevent such a decision being taken.

- At the time of the decision, the senior manager is aware of a risk that implementing that decision may cause the failure of the financial institution.
- In taking the decision, the senior manager's conduct falls “far below what could reasonably be expected” of a person in his position.
- The implementation of the decision causes the failure of the financial institution.

The seriousness of this offence is emphasised by the penalty of up to 7 years imprisonment and an unlimited fine.

How likely is it that directors will be prosecuted under this offence?

In their consultation paper, the FCA and PRA admit that they expect prosecutions under this offence to be rare. In part, this is undoubtedly because significant changes are being made to the overall regulatory structure of financial institutions, with the aim of ensuring that banks and building societies are less likely to fail than they were before the financial crisis.

Aside from this, there are a number of complexities that will make this offence difficult to prosecute. For example, there is no guidance on what constitutes conduct which falls “far” below what might be reasonably be expected of the senior manager. Further, the prosecution must prove a direct causal link between the decision that was made and the failure of the financial institution. In addition, there is the hurdle presented by the subjective test. A prosecutor will need to show that the senior manager appreciated that taking a decision may cause his firm to fail, and that he took the decision anyway.

Will it put people off wanting to be involved in the senior management of a financial institution?

To an extent, the increased regulatory focus on individual accountability within banking, along with the introduction of the criminal offence, has caused concern within the industry that UK banks will struggle to attract and/or retain talented directors; the proposed new regime is tougher than the equivalent in the US and Europe.
In practice, however, the circumstances in which senior managers will be personally liable for the failure of a financial institution will be few and far between. In addition, with proper systems and controls in place, a senior manager should be able to adequately prove that he took steps to prevent misconduct from occurring in his department. Despite the pressure on regulators to take enforcement action against individuals, the FCA and PRA have shown an awareness that there is a need to keep the proposed rules under review, to ensure that non-executives are not put off joining the banking industry.

2. Strict Liability for Senior Managers for regulatory misconduct of staff

The proposed new Senior Managers' Regime focuses on the key decision makers within banks. It requires that firms regularly monitor the fitness and propriety of individuals who carry out senior management functions. From a practical perspective, there is an increased emphasis on responsibility maps, which provide an up-to-date overview of the firm's management and governance arrangements and set out lines of responsibility within the firm. The focus on individual accountability is further demonstrated by the requirement that firms submit a statement of responsibility to the relevant regulator when an individual becomes a senior manager. This statement will provide a record of that manager's role and specific areas of responsibility.

The new rules also propose a reversal of the burden of proof, whereby senior managers are presumed to be culpable if a firm breaches a regulatory requirement in an area for which they are responsible. A senior manager will have a defence if he can prove that he took reasonable steps to prevent the misconduct occurring.

The changes to the regulatory regime are likely to pose a number of new challenges, both for firms and their senior management. Firms will need to ensure that there are clearly defined, transparent reporting lines and robust governance structures in place. Individuals in the business will have to work closely with their colleagues in compliance departments to ensure that adequate systems and controls are in place and that suitable training is provided where necessary. On a personal level, particularly given the strict liability nature of the offence, senior managers will need to have a clear understanding of each of the matters for which they are responsible and take an active role in ensuring that they have adequate levels of information from other areas of the firm. Senior managers will need to be confident that their responsibilities in these areas are being fully discharged.

SOUTH AFRICA

What is South Africa's position towards the conduct of directors of Banks? Are civil or criminal sanctions imposed on banking directors for 'reckless conduct' - a concept that has been described as amounting to "gross negligence"[2] and is expressly prohibited by Section 22(1) of the Companies Act, 2008 ("the Companies Act")?
The conduct of banking directors is governed by both the Companies Act and the Banks Act, 1990 (“the Banks Act”) and, accordingly, banking directors are expected to comply with the standards of care, knowledge and skill that are imposed on general corporate directors by Section 76(3)(c) of the Companies Act, as well as the additional requirements stipulated in banking legislation. In this regard, Section 60(1A) of the Banks Act and Regulation 40 of the current banking regulations has defined and imposed a particular level of care, knowledge and skill required of banking directors in the conduct of their duties.

Notwithstanding the particular standard of knowledge and skill required of banking directors, and the negative socio-economic repercussions that could follow if banks and their custodians fail to achieve this standard, or conduct the business of the bank recklessly, it is submitted that the consequences for such are the same as those for general corporate directors.

In this regard, it appears that Section 60(1B) of the Banks Act draws a distinction between banks that are in liquidation/winding up and banks that are not, and provides that the Registrar of the South African Reserve Bank (“the Registrar”) may institute action in terms of:

- Section 77 of the Companies Act against a director of a bank that is not in winding up/liquidation; or
- Section 424 of the previous Companies Act, 1973 (“the previous Companies Act”) against a director of a Bank that is in winding up/liquidation. Section 424 of the previous Companies Act continues to apply to banks/companies that are in winding up/liquidation[3].

The application of Section 77 of the Companies Act and Section 424 of the previous Companies Act, and the consequences thereof are, however, inconsistent largely because of the process of decriminalization of directors’ misconduct which has been adopted in the current Companies Act. It is submitted that this has created a lacuna in our law, which will only be remedied upon the Minister’s determination that the previous Companies Act no longer applies to banks/companies in winding up/liquidation.

Until this ministerial determination, Section 424 of the previous Companies Act provides that any director knowingly carrying on business recklessly can be held personally responsible for the debts of the company, or can be found guilty of an offence. Consequently, reckless conduct knowingly perpetrated by directors of companies and banks alike that are in winding up/liquidation may amount to criminal conduct.

It was in terms of section 424 of the previous Companies Act that the CEO and Chairman of Regal Treasury Private Bank (“Regal Bank”), Mr JI Levenstein, was convicted, in addition to four other counts of fraud.[4] Upon Mr Levenstein’s appeal of the convictions and sentences, the Supreme Court of Appeal, in October 2013, found Mr Levenstein guilty of knowingly “being a party to the carrying on of Regal’s business in a reckless manner” and confirmed his sentence of
2 years imprisonment. The Supreme Court of Appeal found, inter alia, that “the period of imprisonment imposed is in no way disproportionate to the crime. Indeed it was richly deserved.”[5]

Notwithstanding the views expressed by the Supreme Court of Appeal in the Levenstein matter, the South African legislature has departed from its position to criminalise reckless conduct and has introduced the current Companies Act, which no longer incorporates the criminal sanction as expressed in its former Section 424. Accordingly, should a banking director fall short of the standard of care, knowledge and skill required of him by the Companies Act and Banks Act (in terms of a bank that is not in winding up/liquidation) and/or knowingly carry on the business of the bank in a reckless manner, reliance will now be made on the following, inter alia, provisions of the Companies Act:

- Section 77(2)(b), which provides that directors may be civilly liable for the losses or costs sustained by the bank as a consequence of a breach by that director of the ‘general’ standard of care and skill required in terms of Section 76(3)(c) of the Companies Act;
- Sections 77(3)(b) and 218, which provide that directors may be civilly liable for the loss, damage and costs sustained by the bank if that director acquiesced in the carrying on of business recklessly despite knowing that it was prohibited in terms of section 22(1); or liable to any other person for any loss or damage suffered by that person as a result of contravening the Companies Act; and
- Section 20(6), the general catchall provision, providing that each shareholder has a claim for damages against any person who intentionally or due to gross negligence causes the bank to do anything inconsistent with the Act.

While it can be argued that the incorporation of a criminal sanction for reckless conduct perpetrated by banking directors may be justifiable, it is now the trend of the legislature to decriminalize company law sanctions where possible[6] as "experience under the previous company law regime has shown that criminal sanctions are ineffective as a means of ensuring compliance with the Companies Act, due largely to the failure and reluctance to prosecute for technical offences."[7]

Be that as it may, South African banking directors cannot throw caution to the wind because they may no longer face the same criminal risk highlighted in the Regal matter, as the current Companies Act imposes a wider range of civil claims which may be brought against banking directors in their personal capacities by a greater number of stakeholders of the bank and the public.

CONCLUSION

In conclusion, financial institutions (and above all, banks), today face an unprecedented degree of scrutiny. Failings by banks and individuals working for them continue to dominate the
headlines, and governments around the world have faced sustained pressure to introduce ever-greater levels of scrutiny and regulation. Such pressure, however, has evidently produced very different regulatory responses in different countries. In the UK, the FCA and the PRA have been empowered to pursue criminal actions against individuals whose activities (or inactivity) result in breaches of the regulatory standards now in force. In South Africa, by contrast, the government has deliberately moved away from criminal sanctions in favour of civil penalties. It remains to be seen whether the threat of prison will form a more potent counter to any wrong-doing than the threat of a fine, or indeed whether such sanctions will prevent a crisis on the scale of 2008 in the future.

[1] "Senior Managers" in this context includes directors, along with more junior staff.
[3] And possibly curatorship. See Section 69A(11)(c) – (d) and (12)(c) of the Banks Act
[5] Ibid, para 135 of page 48

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