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A Rock or A Hard Place?

Reporting overseas enforcement action against Senior Managers to the Prudential Regulation Authority.

BACKGROUND

On 7 November 2018, the Prudential Regulation Authority ("PRA") issued two final notices against two individuals who had worked for a major Japanese Banking Group. The cases were a follow on to the PRA's enforcement case in 2017 against the UK arms of two Japanese Banks, in which the PRA levied fines totaling £26 million for failing to inform it that the New York Department of Financial Services ("NYDFS") was about to take enforcement action.

The PRA subsequently took action against two individuals ("A" and "B"), both of whom were board-level Approved Persons at UK authorised firms in the Group. These cases, which resulted in financial penalties of £22,700 and £14,945 respectively, provide a degree of insight into what the PRA is likely to expect in terms of notification when firms and/or individuals are subject to overseas enforcement action in future.

The PRA's case was that there was a failure on the part of both individuals to be open and co-operative with the PRA in breach of APER Statement of Principle ("SoP") 4, which was in force at the time.[1] The breaches centre around the impact of the NYDFS enforcement action on the future of one of them.

Although the PRA brought these cases under the old Approved Persons regime, there is clearly some read through to the Senior Managers and Certification Regime.

FACTS AND FINDINGS

The PRA action arose out of enforcement action taken by the NYDFS in 2014. The relevant facts relating to that action are that the NYDFS took action against the Bank for exercising pressure on an external consultant to remove evidence from an independent report provided to a predecessor regulator. As part of the outcome to the enforcement action, the Bank agreed that a number of executives, including A, would not be permitted to

conduct US banking activities at the firm or its subsidiaries. This was not disclosed to the PRA until mid-November 2014, shortly after the NYDFS action became public. At the same time the firm was in discussions with the PRA about succession planning for A, who was due to retire.

The PRA found that the failure to disclose the existence of the NYDFS' regulatory action was a breach of APER SoP 4 on the part of both A and B. It noted that the lack of disclosure deprived it of the opportunity to consider any impact on A's fitness and propriety arising from the action, and any implications in terms of contingency planning for his succession. It found:

- in respect of A, while he did not know of the potential disciplinary action against him until sometime after B became aware of it, he ought nevertheless to have disclosed it internally and/or to the PRA in the ten or so days between him becoming aware of the potential action, and the outcome being made public; and
- B ought to have disclosed the existence of potential regulatory and disciplinary action against A from the point at which he became aware of the request by the NYDFS that the firm take disciplinary action against a list of individuals, which included A's name. This was the case even though at that time - some 6 weeks prior to the action being made public - the likelihood of any disciplinary action being taken was wholly unclear. While the PRA accepted that B was motivated by a concern for maintaining compliance with NYDFS' confidentiality restrictions, he did not take proper account of his regulatory obligations in the UK and thus fell short of the standards the PRA expected.

LESSONS FOR FIRMS

The clear lesson for firms is that the PRA will expect disclosure of:

- potential overseas regulatory action against Senior Managers; and/or
- any request by an overseas regulator for disciplinary action to be taken by the firm against an individual Senior Manager.

The PRA will expect disclosure to be made regardless of whether the firm is aware of, or has a view on:

- the likelihood of any regulatory or disciplinary action coming to pass;
- the potential outcome of it; or
- the implications of any outcome for the individual concerned.

Having taken appropriate advice, particularly on the interaction between the competing regulatory duties, firms should make any required disclosures to the PRA as soon as possible on finding out that a Senior Manager is potentially subject to overseas enforcement action, even if that means making a limited disclosure in the first instance, and then following it up as and when more detail becomes available.

LESSONS FOR SENIOR MANAGERS AND NOTIFIED NEDS - DISCIPLINARY ACTION AGAINST THEM PERSONALLY

For Senior Managers and Notified NEDs, the position is relatively clear: all Senior Managers and Notified NEDs are subject to Senior Manager Conduct Rule 4 ("SMCR 4"), which requires them to disclose appropriately any information of which the FCA or PRA would reasonably expect notice. This goes beyond Individual Conduct Rule 3 ("CR 3"), which requires a person to be open and co-operative with the FCA, the PRA and other regulators.

The PRA explains in its Supervisory Statement on the SMCR[2] that the difference between CR 3 and SMCR 4 is that the former relates primarily to responses from individuals to regulatory requests. SMCR 4 imposes a higher, proactive, duty to disclose even when no request has been made.

The lessons for Senior Managers arising out of the PRA's case against A are that:

- if a Senior Manager has information relating to enforcement action against them personally, they should disclose it - and the implications for them personally - regardless of the likelihood or nature of any potential outcome; and
- in terms of timing, the PRA's view appears to be that this should happen in relatively short order.[3] The case against A was that he failed to disclose for less than two working weeks. So, the PRA is likely to expect disclosure to occur within days.

LESSONS FOR SENIOR MANAGERS AND NOTIFIED NEDS WHO BECOME AWARE OF POTENTIAL REGULATORY ACTION AGAINST COLLEAGUES

The PRA's case against B was that, having become aware of potential enforcement action against A, he failed to disclose it, either internally using the firm's own reporting lines, or directly to the PRA. As a result, the PRA was not made aware of any risk to A's position until after that risk had crystallised.

Given the content of SMCR 4, similar considerations apply to Senior Managers who become aware of potential regulatory action against a colleague who is a Senior Manager. They should disclose that information as soon as possible, even if the outcome of the proposed regulatory action is unclear.

The PRA made clear that the duty to disclose extends to a situation where a Senior Manager becomes aware of a request by an overseas regulator for the firm to take appropriate disciplinary action against a colleague or colleagues. This would be the case even where is it unclear whether any disciplinary action will be taken, or the nature or outcome of it.

DISCLOSURE VIA INTERNAL REPORTING LINES? SUFFICIENT?

What is less clear from the PRA's guidance on SMCR 4 is whether - in these circumstances - a disclosure via the firm's internal reporting lines would be sufficient. The Final Notice for A states that the Bank had internal reporting procedures in its compliance manual which required disclosure of information concerning the enforcement action to colleagues responsible for reporting to the FCA. The PRA noted that A ought to have made use of that channel or, failing that, to have disclosed directly to the PRA.

Guidance to this effect appeared in APER as it stood at the time. However, no such guidance appears in the PRA's Supervisory Statement on SMCR 4 (though something similar does appear in the guidance for CR 3).

While the circumstances are inevitably fact-specific, we suspect that the PRA might be satisfied if the Senior Manager concerned uses the relevant internal reporting channel so that the firm can make a disclosure to the PRA (provided the firm does in fact make the report in a timely manner). However, to ensure that the Senior Manager cannot be said by the PRA to have breached SMCR 4, we would suggest that the Senior Manager should:

- follow up on any internal report to check whether it has been forwarded to the regulator; and
- take appropriate advice and consider disclosing directly to the PRA if the firm has not made a report, or there is a risk of it not doing so in a timely manner.

COMPETING OR CONFLICTING REGULATORY REQUIREMENTS

The PRA recognised in both cases that the individuals were subject to other regulatory requirements (in this case imposed by the NYDFS). One such requirement was to keep the enforcement action confidential. While the PRA Notice recognises that there may be conflicting regulatory requirements, it notes that this does not absolve individuals of their UK regulatory responsibilities. As such, where there are conflicting or competing regulatory requirements, Senior Managers should:

- consider - promptly and fully - their own obligations to UK regulators, including taking appropriate advice at a sufficiently early stage; and
- consider and discharge their UK regulatory obligations promptly and properly, whatever the competing regulatory priorities and requirements.

While this is not new in and of itself, the PRA made this point particularly starkly in the Final Notice, which provides an indication of the importance it attaches to the issue.

INSTRUCTIONS FROM THE GROUP

One final feature of the case against B is that the PRA noted that where there is a UK regulatory obligation to disclose, board members in particular must "demonstrate leadership and conduct themselves with a commensurate level of candour, independence and challenge."

It went on to say that this meant, in international groups, executives must be prepared, if required to discharge UK regulatory responsibilities, to:

- challenge directions from the Group; or even
- take action that may be contrary to directions given or a decision made by the Group.

In practice, this means that Senior Managers ought to think carefully before accepting an instruction from the Group that they should not disclose to the PRA, and should take their own advice if in any doubt as to their position. The PRA may well expect the individual to ignore instructions coming from the Group if their own regulatory obligations are engaged.

FINAL THOUGHTS

The PRA's clear driver is that - as a prudential regulator - it needs to be in a position to assess not only the fitness and propriety of any affected senior individuals, but also the potential impact on the firm of any overseas regulatory action. It could not do so in this case, as it did not find out about the NYDFS action until after the event.

The fact that the failure to disclose in this case happened at a time when the firm was in discussions with the PRA about succession planning for A appears to have exacerbated the issue.

This case is essentially about the PRA making clear that firms and individuals must make some form of disclosure about overseas regulatory action, even if this means just picking up the phone and having a high level conversation which is then followed up with more detail later.

We suspect that the PRA would initially have been content, in this case, with an indication (either from the firm or the individuals) that A was in the NYDFS' crosshairs, and at that stage there was no certainty as to what the outcome might be. That initial notification could then have been followed up as more information became available.

We would expect the PRA to be sensitive to the potential impact of confidentiality restrictions imposed by overseas regulators when determining what level of detail it expects to be provided with, albeit that it is very unlikely to compromise on the principle that it should be informed. That said, in deciding to make disclosure to the PRA in such circumstances, firms and individuals should take advice promptly on their obligations to ensure that they consider the interaction between any conflicting international regulatory requirements.

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[1]APER SoP 4, as it stood at the time, required an Approved Person to be open and co-operative with the FCA, PRA and other regulators, and disclose appropriately to the PRA and FCA anything of which they would reasonably expect notice.
[2] *Strengthening Individual Accountability in Banking - SS28/15.* The latest version is dated July 2018, and comes into effect on 10 December 2018 - https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2018/ss2815update.pdf?la=en&hash=39EC46AE5FD217724BB307C420B80A4E09F42A24
[3] This is particularly the case when those matters might be relevant to the PRA's judgement as to whether a Senior Manager remains a fit and proper person.