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Banking and finance disputes review

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From the editor

Welcome to the latest edition of the *Banking and finance disputes review*, the journal which highlights and analyses developments in dispute resolution relevant to financial institutions.

In this edition, we review a selection of recent significant decisions and consider some regulatory developments. Twin themes emerge from these articles: continuing litigation by disappointed investors against banks and, increasingly, other financial intermediaries and a heightened focus on regulation of financial institutions. Both of these themes emerge from the continuing fallout from the financial crisis and can be expected to continue. In particular, 2014 may see further cases as the six year limitation period reaches expiry for events occurring in 2008.

Claims by investors against their counterparties are dealt with in the article *Derivatives close-outs: recent case law* and the case notes on *Graiseley v Barclays* and *Green and Rowley v Royal Bank of Scotland plc*. The related, growing field of claims by investors against other financial intermediaries is dealt with in the article *Liability of an agent in a finance transaction: Torre v RBS* and the case note on *Forsta AP-Fonden v Bank of New York Mellon*.

We turn to regulation in the UK with the articles *Senior Management in the Regulatory Spotlight* and *Civil Liability of Credit Rating Agencies* and regulation in the US with *Increased Focus on Financial Institutions in Recent US FCPA Matters*. Finally, we provide an insurance perspective on the issues raised in this edition of the *Banking and finance disputes review*.

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Derivatives close-outs – recent case law

The ISDA Master Agreements set out a number of mechanisms by which a net payment is to be determined on the early termination of derivative transactions. However, applying these mechanisms is not always without difficulty or free from uncertainty, particularly in times of severe market dislocation. This article looks at two recent areas of uncertainty addressed by the English Courts – the ambit of the determining party's discretion and what has become known as the 'clean valuation principle'.

The basics

Essentially, under both versions of the Master Agreement a close-out netting approach applies. That is, values are calculated for the terminated transactions and netted off to derive a single net sum. That amount may be due to either party, depending on the state of the market at the time of the calculation.

Under the 1992 Master Agreement, the parties will have chosen one of two ways of calculating that net amount – 'Market Quotation' or 'Loss'. Market Quotation involves soliciting quotes from leading dealers for entering into replacement trades. If too few quotes are received, or the quotes are not commercially reasonable, Loss is used as a fall-back position. Loss is more flexible and subjective, essentially requiring the determining party to produce an estimate of the total losses and gains reasonably and in good faith.

Under the 2002 Master Agreement there is only one method – the 'Close-out Amount'. This requires the determining party to calculate the replacement value of the trades in good faith, using commercially reasonable procedures in order to produce a commercially reasonable result. The 2002 ISDA Agreement provides guidance as to how to do that – a process which may involve the use of external or internal data.

Standard of reasonableness

The definitions of Loss and Close-out Amount both use the word 'reasonable'. This raises the question – what standard of reasonableness applies? Is it a *Wednesbury* standard – that is, the party's calculation is reasonable unless it is a calculation that no reasonable party acting reasonably could have made? Or does it mean reasonable in an objective sense? As this goes to the ambit of the discretion of the determining party, it may be thought to be a reasonably fundamental question. However, perhaps surprisingly, it is not a question to which the case law always provides a definitive answer.

There is no direct authority in relation to the 1992 Master Agreement but arguably the position is clearer under the 2002 Master Agreement. The definition of 'Close-out Amount' requires commercially reasonable procedures to produce a commercially reasonable result. The imposition of a reasonableness standard on both process and outcome and use of the word 'commercially' suggests that an objective standard applies. This was the conclusion reached in a brief obiter paragraph of Briggs J in *Lehman Brothers International (Europe) v Lehman Brothers Finance* [2012] EWHC 1072 (Ch), the only English judgment to expressly address this issue. Further support for this conclusion is given by *Barclays v Unicredit* [2012] EWHC 3655 (Comm), in which a discretion in a guarantee to be exercised in a 'commercially reasonable' manner was interpreted as requiring an objective standard – a conclusion which the Court found to be reinforced by the use of the word 'commercially'.

The objective standard of reasonableness still permits a range of permissible procedures and results: in *LBIE v LBF*, Briggs J commented that this 'leaves a bracket or range both of procedures and results within which the Determining Party may choose, even if the court, carrying out the exercise itself, might have come to a different conclusion'.

Life of the clean valuation principle – the 1992 ISDA Master Agreement

This principle originated in *ANZ v Société Générale* [2000] CLC 833 – a dispute about the calculation of Loss in relation to Dollar/Rouble foreign exchange forwards. In the Schedule to their 1992 Master Agreement the parties had provided for the occurrence of a Russian banking moratorium in two respects. First, it would be an Additional Termination Event. Second, assuming it decided not to terminate, in such circumstances SG would have the option to make its payments by alternative methods which would be less attractive to ANZ – such as payment in Roubles.

In 1998 Russia declared a banking moratorium, SG terminated and calculated the close-out payment – which ANZ disputed.

SG argued that, in determining Loss, it could take into account the alternative payment methods provision. In other words, it could determine Loss on the assumption that, had it not terminated, it would probably have made its future payments in accordance with one of those less favourable alternative methods. That would have made the transactions less valuable to ANZ, reducing the close-out payment from $17 million to less than $1 million.

To address the point, the Court of Appeal considered language within the definitions of 'Market Quotation' and (to a lesser extent) 'Loss', which requires the determining party to assume the satisfaction of 'each applicable condition precedent'.

This language had generally been understood as dealing with a concern that would otherwise arise from the fact that, section 2(a)(iii) of the Master Agreement makes a party's regular payment obligations conditional on certain conditions precedent being satisfied – one of which is that there is no Event of Default outstanding. As a result, following an Event of Default the non-defaulting party's future payment obligations are suspended. Consequently, to value them, it is necessary to assume the satisfaction of any 'conditions precedent' which would otherwise suspend those obligations, such as the absence of an Event of Default.

However, unexpectedly the Court of Appeal interpreted 'conditions precedent' widely and found that not triggering the alternative payment methods was also a condition precedent which had to be assumed to be satisfied under Market Quotation and Loss. Although it was not expressly stated to be a condition precedent in the contract, the Court of Appeal found that it was captured by the reference in section 2(a)(iii) to 'each other applicable condition precedent specified in this Agreement'. This approach, the Court of Appeal described as valuing 'clean', whereas to take the alternative payment methods into account would be to value 'dirty'.

The decision was controversial because, by interpreting 'conditions precedent' so widely, the Court was effectively assuming important commercial terms out of the valuation process. Unfortunately, however, the principle has been upheld in a number of subsequent cases, most recently, by the Court of Appeal in *Britannia Bulk v Bulk Trading* [2012] EWCA Civ 419.

Death of the clean valuation principle – the 2002 ISDA Master Agreement

In *LBIE v LBF* the English Courts considered whether the clean valuation principle applied to the 2002 Master Agreement 'Close-out Amount' concept.

The background to this case was that LBIE had executed various derivative trades with clients and had then transferred certain risks associated with them to LBF via back-to-back trades under a Master Agreement which incorporated the 2002 Close-out Amount provision. LBIE and LBF also executed a side letter which changed how termination of the back-to-back transactions would work – so as to protect LBIE against certain risks if a client defaulted.

Lehman's insolvency in 2008 constituted an Event of Default, first in respect of LBF, triggering Automatic Early Termination of the back-to-back transactions and determination of the Close-out Amount by LBIE. The question that arose was whether the terms of the side letter should be taken into account. LBIE argued that they should be. LBF argued that they should be excluded by virtue of the clean valuation principle. This was not a minor point – it was worth approximately $1 billion.

At first instance, the Court decided that the clean valuation principle applied and effectively required the fundamental economic provisions of the side letter to be assumed away.

However, the Court of Appeal recognised that the 2002 close-out provisions differed from the 1992 provisions in a number of material respects. In particular, they expressly require the valuation, not just of payment obligations, but of all material terms plus option rights and

the condition precedent wording in Section 2(a)(iii) is tighter. The Court of Appeal also accepted that the clean valuation principle could lead to wholly uncommercial results.

Accordingly, in a welcome decision, it held that the 2002 Master Agreement does not preserve the value clean principle in the form that applies under the 1992 Master Agreement. The side letter should be taken into account.

Postscript

On 20 March 2014, the Court of Appeal upheld the first instance decision in *Barclays v Unicredit* (the judgment is at [2014] EWCA Civ 302). The Court discussed 'commercially reasonable' but added that its comments did not apply to the interpretation of this phrase in the 2002 Master Agreement.

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Liability of an agent in a finance transaction

Torre Asset Funding v RBS [2013] EWHC 2670 (Ch)

The High Court decision of *Torre v RBS* has attracted much interest as a comprehensive judicial examination of the scope of an agent's role in a complex structured finance transaction. Norton Rose Fulbright LLP acted for the agent in its successful defence against claims by an investor for loss of its investment, following the collapse of the finance vehicle in the financial crisis. In this note, we examine various aspects of *Torre v RBS*, including the scope of agent liability.

In summary, the High Court gave a narrow construction to the scope of an agent's duties in a finance transaction. It also gave guidance on other issues of critical importance to participants in the financial markets, including the construction of some standard terms in the Loan Market Association ('LMA') loan agreements and the role of causation in limiting liability for misstatements and omissions.

The Royal Bank of Scotland plc ('RBS') successfully argued that it had no duty as agent to pass on to an investor information that constituted an event of default and that its omission to pass on this information did not cause any loss to the investor.

Facts

The claim concerned the investment by Torre Asset Funding Limited ('Torre') in the junior mezzanine tranche of a structured loan to a property company, Dunedin Property Industrial Fund (Holdings) Ltd ('Dunedin'). RBS created the finance structure and took a number of roles including lender, equity participant and, in particular, agent at the junior mezzanine funding level.

During July 2007, there were a number of emails between Dunedin and RBS regarding the performance of the transaction and giving projections of future performance. It became clear that according to these projections the transaction would eventually not have sufficient cash flow to service the most junior layers of interest. The emails then discussed restructuring the transaction to roll up these interest payments. The restructuring never occurred because a senior lender withheld its consent and the transaction collapsed soon after the onset of the financial crisis in 2008.

Torre claimed that RBS, in its capacity as agent, should have informed it of the July 2007 discussions because they constituted an event of default, and that it would then have sold its interest in the loans before Dunedin collapsed in 2008. Torre also made a number of claims regarding other documents not forwarded by RBS to Torre and communications between RBS and Torre.

RBS argued that the discussions did not constitute an event of default, that it had no duty as agent to inform Torre of these discussions, and that its omission to inform Torre did not cause Torre's subsequent loss of its investment.

Event of default

Mr Justice Sales held that the discussions with Dunedin in July 2007 fell within the standard LMA insolvency event of default: that is, Dunedin '…by reason of actual or anticipated financial difficulties, commences negotiations with one or more of its creditors with a view to rescheduling any of its indebtedness…'. The financial projections which showed that Dunedin would eventually be unable to service the junior interest amounted to 'anticipated financial difficulties' and these difficulties were substantial.

This takes an extremely wide view of the LMA insolvency event of default. Certainly, none of the participants at the time contemplated that their email exchange might constitute a default. How can a borrower avoid a conservative approach to forecasting being interpreted as a statement of anticipated difficulties? Until this question is answered, the LMA insolvency event of default may impede proper financial planning by borrowers. Perhaps the LMA will tighten the wording of this clause: a gloss on the word 'anticipated' to make it clear that it refers to a near certain expectation of a future event rather than a foreseeable possibility would be sufficient. Arguably, 'anticipated' could simply be removed entirely.

Breach of duty

Sales J held that there was no breach of duty by RBS in omitting to inform Torre of the July 2007 discussions, even though they constituted an event of default. The duties of the agent were defined exhaustively by the express terms of the agreement between the parties. The creation of an agency relationship did not automatically cause the common law to import a specific bundle of duties associated with an agency role. Nor was there an implied term importing a duty to inform. However, the contract did contain an express exclusion of fiduciary responsibilities of the agent – without this, presumably some obligations of this type may have been present.

Financial institutions acting as agents will welcome this decision. They may continue to regard their role as mainly 'mechanical and administrative' and circumscribed by the particular wording of the agreement. Sales J had no time for the role of agency imposing by itself any duties on the agent: this was far too vague for a commercial contract. However, he did add a reminder that agency was more than acting as a postbox and could involve requirements to exercise discretion appropriately.

Although it was not argued by the claimants, Sales J raised of his own volition a question as to whether an obligation to pass on information might have arisen not from a duty to do so but from a power to do so associated with a duty to exercise that power in a certain way. It will be interesting to see whether this argument is raised in a future case – it appears to face serious obstacles.

Sales J also considered the exclusion clause – again a standard LMA form – and found that it extended to omissions to act and would therefore have applied in this case.

Causation

Sales J found that even if there had been a breach of duty, the omission to inform Torre did not cause Torre's loss. The purpose of the information duty was to enable Torre to exercise its rights under the loans effectively, not to help it decide whether or not to continue its investment. So losses in relation to investment decisions fell outside the scope of foreseeable losses flowing from breach of the duty and were not caused by it.

Where the claim is for an omission to pass on information, proving causation may be particularly problematical. A claimant has to show not only that on the counterfactual assumption that the information had been passed on that it would have acted differently and so avoided a loss, but also that the loss suffered fell within the scope of the duty to act. This latter point has not been sufficiently highlighted previously and is a substantial burden for a claimant to overcome.

Sales J also dealt in passing with a factual causation argument that would have defeated the claim. If it had come to light that an event of default had occurred, this would have reduced the price of the loans, thereby removing the incentive for Torre to sell them. In other words, telling Torre the event of default had occurred would not have caused them to sell the loans because the sale price would be reduced due to the event of default and they would accordingly obtain no advantage from a sale. Although it was only a brief discussion, this argument could be used in a wide variety of claims to negate causation.

Conclusion

Financial institutions will be encouraged by the strict, commercial approach to construction of the agency role. However, it is the ruminations on causation that may prove more significant. Torre v RBS illustrates the variety of robust causation-based defences to claims based on omissions and misstatements. Where liability for a breach of duty is admitted – consider cases based on LIBOR manipulation, for instance – then it may be difficulties in proving causation that close the floodgates.

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Graiseley Properties Ltd & Ors v Barclays Bank plc [2013] EWHC 67 (Comm)

In this interim application, the Court of Appeal gave permission for claims based on the fixing of LIBOR to proceed to trial. The Court considered two separate appeals; both concerned a derivative linked to LIBOR entered into by a bank with a claimant as part of that claimant's borrowing arrangements. The Court of Appeal found that it was at least arguable that the banks had impliedly represented that LIBOR was not manipulated and that this representation entitled the claimants to rescind those derivatives. The first of these claims is due to be heard in April 2014.

Although this was only an interim application and the relevant standard was only that the claims were 'arguable', the judgment and comments of the Court of Appeal have been examined very closely. Banks have been asking two key questions: Could the claim succeed? If it does, will this open the floodgates to a host of similar claims?

We identify a few key issues that the banks might contest in these cases and which, depending on the outcome, might then have an impact on similar claims.

Misrepresentation

The claims are based on allegation that each bank impliedly represented that it was not attempting to manipulate LIBOR, rather than that it failed to disclose that it was manipulating LIBOR. It seems likely that this is because an omission will only constitute a misrepresentation in certain limited circumstances: for instance, if there is a particular relationship between the parties (such as insurer and insured) or a voluntary assumption of responsibility by the representor in relation to the matters to be disclosed (see *Banque Financière de la Cité SA v Westgate Insurance Co Ltd* [1989] 2 All ER 952). Neither of these are apparent in this case.

Therefore, the claimants have put their claims in terms of a positive, implied representation. Assuming that there are no special circumstances – that is, there was no particular discussion of the nature or significance of LIBOR – this amounts to an allegation that merely including LIBOR as the reference rate in the termsheet or in pre-contractual negotiations involves making an (implied) statement that it was not being manipulated.

Longmore LJ appeared to be sympathetic to the argument that particular pre-contractual conduct may amount to an implied representation. He used the analogy of a restaurant customer sitting down to a meal being an implied representation that he had the means to pay. This is similar to the Court of Appeal decision in *Contex Drouzhba Ltd v Wiseman* [2007] EWCA Civ 2001, where a director, in signing a supply agreement, impliedly represented that his company would have the means to pay for any goods ordered in the future. However, if the scope of implied representations resulting from pre-contractual conduct is widened significantly, this risks allowing a general duty of disclosure in pre-contract negotiations. This has been firmly resisted by English courts in the past.

A finding in these cases that the inclusion of LIBOR as a reference rate did not by itself constitute an implied representation that LIBOR was not being manipulated would be a compelling precedent in future cases. Although a finding of fact does not strictly bind any future court dealing with a different set of facts, the point is sufficiently generic that judges would be likely to follow the decision in other cases where there was no express discussion about the use of LIBOR.

Conversely, if the court finds that there was an implied representation, without any particular discussion of LIBOR, then this could apply to many derivatives and other contracts linked to LIBOR entered into by banks with their customers.

Fraud and attribution of knowledge

The claimants included allegations that there were misrepresentations about both past and future manipulation of LIBOR. As to past manipulation, it may be challenging for the claimants to show that they relied on this representation and were induced by it to enter into the contract, as it did not directly affect payments to be made under the contracts. As to future manipulation, technically this is an expression of opinion, not fact. Excluding certain special cases, for an opinion to constitute a misrepresentation, the representor must not honestly hold that opinion. In other words, it must be made fraudulently.

Accordingly, the claimants in these cases allege not only that the misrepresentations were false, but that they were fraudulent. In particular, they allege that each bank represented that it did not intend to manipulate LIBOR when it did have that intention.

Furthermore, fraud is not only relevant to show that a statement that LIBOR would not be fixed in the future was a misrepresentation. It also limits the judicial discretion not to award rescission, prevents any exclusion clause from limiting liability, and lowers the burden for showing that the representation induced the claimant to enter into the contract.

This aspect of these cases will depend on a detailed analysis of exactly what each bank did in relation to LIBOR and what it knew about what it and other banks were doing. This in turn raises questions as to the attribution of knowledge of individual employees of the bank to the bank itself. It is likely that the individual bank employee who (allegedly) made the implied representation that LIBOR was not being manipulated was not the same person who it is alleged was actually manipulating LIBOR – fraud requires attributing both the representation and the knowledge simultaneously to the bank, in order to find dishonesty.

Any finding of fraud (or absence of fraud) will be relevant to any other case involving that bank at that particular time. A finding that limits attribution of knowledge could be applicable to other banks and many fact situations.

Rescission

This is the joker in the pack. A claim to rescind the contract is available even if the misrepresentation is not fraudulent. Such a claim avoids any issues as to whether the misrepresentation caused the loss and, if so, how much loss is attributable to the misrepresentation. However, the remedy is subject to various established bars and, where the misrepresentation is not fraudulent, a wide judicial discretion.

Rescission would allow claimants to unwind the contract and reverse all payments made under it, even where the contract has been fully performed. Clearly, the amounts payable may have no connection with the misrepresentation itself or its consequences.

Although these consequences indicate that rescission may not be the appropriate remedy, whether a judge grants rescission for a non-fraudulent misrepresentation will depend on the particular merits of the claim. Any precedent on this issue is unlikely to provide guidance in other cases.

Conclusion

If there are no special features of the pre-contractual negotiations, then these cases may provide guidance as to whether banks will be held to have made implied representations as to the manipulation of LIBOR. Also, any finding of that knowledge as to LIBOR manipulation of a bank employee could be attributed to its employer may definitively resolve this issue for that bank. And legal guidance on attribution of knowledge may help to determine exactly what other banks must prove to avoid liability. If banks lose on these points, and especially if the judge grants rescission, the market can expect an avalanche of LIBOR-related claims to follow, with success in each depending on its particular facts.

Postscript

On 7 April 2014, Barclays announced that it had settled its dispute with Graiseley Properties. It is reported that, in return for Graiseley dropping its claim against Barclays, the bank restructured the £70 million that Graiseley owed under the contested interest rate swap.

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Green and Rowley v Royal Bank of Scotland Plc [2013] EWCA Civ 1197

Where a mis-selling claim was time-barred under the statutory regime of liability for breach of Conduct of Business Rules, there was no co-extensive common law duty of care which could also found liability.

Facts

It was common ground that the bank owed various statutory duties under the Conduct of Business ('COB') Rules, including a duty to (a) take reasonable steps to communicate information in a way which was clear, fair and not misleading (r. 2.1.3) and (b) to take reasonable steps to ensure that a private customer understood the nature of the risks involved in their transactions (r. 5.4.3). The appellants' statutory claim under the Financial Services and Markets Act 2000, s. 150 (now replaced by s.138D) was time-barred. However, the appellants contended that the bank had assumed an advisory duty in respect of the swap at common law. At first instance, HHJ Waksman QC rejected that argument on the basis that the bank did not cross the line which separated the activity of giving information about and selling a product and the activity of giving advice (the appellants had signed the bank's Terms of Business, which stated that the bank would act on an execution-only basis and would not provide the customer with advice on the merits of a particular transaction).

That finding was not challenged on appeal. The issue on appeal was a narrow one: whether or not there existed at common law a duty of care co-extensive with those prescribed by the COB Rules.

Decision

The Court of Appeal held that the mere existence of the COB Rules did not give rise to a co-extensive common law duty of care for, in summary, the following reasons:

- Absent the bank crossing the line between giving information and selling the product and providing advice, there was no justification or need for imposing a common law duty independent of, but co-extensive with, the statutory remedy provided by s. 150.
- Neither r. 2.3.1, nor 5.4.3 provided any pointer as to the assumption of a duty of care to advise or as to the appropriateness of imposing such a duty, as both imposed statutory duties where banks had an execution-only relationship with their counterparties, as well as where they had undertaken an advisory role. For example, r. 5.4.3 imposed a duty to take reasonable steps to ensure that the private customer understood the nature of the risks involved on both a firm which made a personal recommendation of a transaction and on a firm which arranged or executed a transaction.

However, the Court of Appeal did not cast doubt on the trial judge's observation that, if the bank had undertaken an advisory duty, the content of that duty would have been in part informed by the content of COB Rules 2.1.3 and 5.4.3 (see paragraph 18 of the judgment).

Comment

As the Court of Appeal pointed out, if they had found a parallel common law duty of care, this would have completely undermined s.150 as the statutory duty in that section is expressly limited to 'private persons'.

So it is not surprising that they rejected this idea in the most trenchant terms. However, this gives little guidance as to more plausible arguments trying to found a common law duty of care on breaches of statutory regulation. The one point that is clear is that a statutory duty will not of itself bring about the creation of a co-extensive common law duty.

Also notable is that this is another case based on omission to provide information (the amount of break costs) as opposed to provision of misleading information and that, given the findings of fact, practically the whole judgment seems to be obiter.

The observation that the COB rules will inform the content of an advisory duty may be relevant in future mis-selling cases based on an advisory role.

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Forsta AP-Fonden v Bank of New York Mellon [2013] EWHC 3127 (Comm)

The global custodian under a securities lending arrangement was liable for the entire loss in value of securities for failing adequately to disclose problems with those securities.

Facts

Bank of New York Mellon ("the Bank") was the global custodian under a securities lending arrangement with Forsta AP-Fonden ("Forsta"), a Swedish pension fund. The Bank managed the collateral investments under this arrangement on a discretionary basis.

The Bank, acting on behalf of Forsta, invested in notes issued by Sigma Finance Corporation (the "Sigma notes"). After the onset of the financial crisis, the Bank informed Forsta of a decline in the market value of these notes. They subsequently lost almost all value.

Decision

Blair J held that the Bank was not in breach of contract for acquiring and continuing to hold the Sigma notes. However, there was a duty to inform the client that there was a serious risk of loss in respect of the Sigma notes. Although the Bank did inform the client of the situation in May 2008, this disclosure was inadequate. In particular, it was inconsistent with the disclosure the Bank was making to other clients at that time; it did not give a fair view of the Bank's concerns about the Sigma notes.

The inadequate disclosure constituted a negligent misrepresentation and also a breach of its contractual duty to use reasonable care in fulfilling its obligations as securities lending agent. Blair J found, on the facts, that if it had been properly informed, Forsta would have exited the investment in Sigma notes. Blair J also held that the risk that materialised was within the reasonable contemplation of the parties and therefore was recoverable – following the approach to causation set out in *The Achilleas* [2008] UKHL 48.

Comment

In finding that the inadequate disclosure constituted a breach of duty, the judge was heavily influenced by the fact that the Bank was advising other clients very differently at the same time. He was thus able to find that even though the advice consisted largely of prediction and opinion, it was inaccurate and made negligently.

The findings on causation, including foreseeability, are at odds with the approach in Torre v RBS. In particular, Blair J relied only on *The Achilleas* and did not cite or discuss the 'assumption of responsibility' limitation on causation set out in *Saamco* [1997] AC 191, *Haugesund Kommune v Depfa* [2011] EWCA Civ 33 and later cases. Assessing liability for loss of value of an investment without the limitation set out in these cases leads to the very broad approach seen in this case.

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Szepietowski v The National Crime Agency [2013] UKSC 65

The Supreme Court has failed to agree on the nature of a charge that had no underlying debt attached and on the scope of the equitable doctrine of marshalling of securities.

Facts

The charge arose after an investigation by the Serious Organised Crime Agency (SOCA). SOCA attempted to seize certain properties under the Proceeds of Crime Act 2002; this culminated in an agreement under which a second charge was created in favour of SOCA with a 'Secured Amount' of £1.24m in settlement of SOCA's claim to confiscate the property. However, despite the definition of Secured Amount, there was no express creation or acknowledgment of indebtedness in the settlement agreement. The holder of the first charge enforced its security, even though it also held a first charge over another property.

Decision

The Supreme Court were unanimous in deciding that marshalling did not apply to the particular charge, as a matter of construction of the particular, unusual documents. However, they differed on whether it was available as a matter of principle.

For further details of the struggles of the Supreme Court to apply the principles of marshalling, see the inset box: Marshalling. But this should not obscure the more important point: the Supreme Court were faced with what looked like a charge with no underlying debt. Was this a contradiction in terms? If not, how did it work?

The majority of the Supreme Court appeared to find that there was some sort of charge but did not squarely address the contradictory nature of a charge without a debt.

Reasoning of the individual judges

Lord Neuberger, with whom Lord Reed agreed, held that there was no underlying debt, except that the charge was accompanied by a contingent obligation to pay a sum out of the net proceeds of sale of the property. This is rather like a limited recourse provision in a securitisation. While this avoids the problem of a charge with no debt, it is hard to see how Lord Neuberger arrived at this interpretation from the documents, particularly as he is quite clear that the settlement agreement did not create or acknowledge any indebtedness.

Lord Sumption held that there was no underlying personal liability and the sole effect of the transaction was to confer a contingent interest in the charged asset, not as the means to recovery of a liability, but as a primary benefit. This construction avoids the contradiction of a charge without a debt, seeing the interest as a separate distinct type of proprietary interest, perhaps arising from a constructive trust. However, his short judgment does not go into further detail – particularly as to how this construction is consistent with the terms of the agreement.

Lord Harnwath referred to the problem of a charge without a debt being a 'contradiction in terms' without coming to any clear expression as to its juridical basis, although he was clear that the charge in this case fell into that category. He felt that such charges would be very rare and should be considered in their particular factual contexts.

Lord Hughes considered the situation where the chargor underwrote the debt of another by putting up security but did not enter into a personal guarantee, so that there was an underlying debt but not one necessarily owed by the chargor. In this way, it relates to situations common in international financings, for instance where there is a security trustee or group of companies giving security. His reasoning is relatively undeveloped, but seems to imply that there must always be some 'liability' from the chargor to the chargee, although he does not suggest what that might be.

Conclusion

The Supreme Court's reasoning is varied and undeveloped. Only Lord Sumption gave an interpretation of the underlying agreement that is consistent with the orthodox interpretation of a charge, by finding that the interest created was not a charge at all. It may be that the other judgments should be confined to the particular facts of the case, although they include some interesting discussion as to the nature of charges and their use in finance transactions.

Marshalling

Marshalling works as follows. Take a single debtor D and two creditors C1 and C2. C1 has a first mortage over property A and property B. C2 has a second mortgage over property A. If C1 enforces its security over property B and C2 enforces its security over property A, both may recover their debts. However, if C1 chooses to enforce its security over property A and the recovery is insufficient to provide for both debts, C2 may be left as an unsecured creditor. In this situation, equity steps in and allows C2 to take advantage of the security over property B: this is the process known as marshalling. The basis for this -- so far as the Supreme Court could agree -- is that it is unconscionable for C1 to be able to disadvantage C2 by its choice, in circumstances where it should not make any difference to D.

In this case, the majority in the Supreme Court held that as there was no underlying debt, once the charge over property A had been enforced, there was nothing to which the principle of marshalling could be applied. The minority held that the principle was intended to achieve justice between creditors, not between creditor and debtor, and so marshalling was applicable.

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Senior management in the regulatory spotlight

This article considers some of the ways in which the Financial Conduct Authority (the FCA) is seeking to hold individuals within financial institutions to account and how the regulatory regime for senior managers is changing

Introduction

The FCA has made clear its view that responsibility for the culture of firms sits at the top: if managers create the right culture, good regulatory practice and procedures will naturally follow. Consequently, where they share responsibility for conduct failings, the FCA will seek to hold senior managers to account as part of its credible deterrence strategy. High profile enforcement action against senior individuals has included action in connection with inadequate corporate governance arrangements (Kumagai, May 2012); oversight failures (Cummings, September 2012); failure to notify the regulator (Thiam, March 2013); paying insufficient regard to financial information and inadequate advice to the board (Willford, December 2013).

Where action is taken against individuals, the enhanced penalty regime in force since 2010 can result in higher fines based on a percentage of relevant income which may also be increased in certain circumstances for even greater deterrent effect (as in the March 2013 Carrimjee Decision Notice).

In addition, the publication of Decision Notices and the FCA's recently acquired power to publish details concerning Warning Notices have raised the stakes for individuals. Although the FCA has confirmed that it will not normally identify individuals at the Warning Notice stage, preserving anonymity will be more difficult for key members of the senior management team, where not naming them could lead to others being mistakenly suspected or where publication is necessary to quash rumours.

However, enforcement is not the only way in which the FCA has been seeking to achieve its aims in relation to senior managers. The FCA is also making increased use of existing supervisory tools such as attestations, potentially with a view to facilitating future enforcement action, and is considering further enhancements to the regulatory regime as a result of the recommendations made by the Parliamentary Commission on Banking Standards. We will look at each of these in turn.

Attestations

The FCA has recognised that it is often difficult to hold senior managers to account where they are removed from day-to-day operations and the establishment and maintenance of procedures and controls. In his evidence to the Treasury Select Committee in September 2013, Martin Wheatley, Chief Executive of the FCA, commented:

'It has been hard to nail an individual against responsibility because matrix organisation structures, committee decision-making means that individuals always defuse responsibility and it ends up that you have to take action against a committee. So 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.'

Making increased use of attestations is one of the ways in which the FCA is seeking to bridge this evidential gap and place accountability directly at the feet of senior managers.

Attestations are an informal tool whereby the FCA seeks an assurance of a particular compliance matter. They can be forwards or backwards looking and the FCA may look to a senior individual to put his or her name to a particular measure, effectively giving an implementation guarantee.

Those asked to give attestations are often placed in a difficult position, possibly concerned that a refusal may be perceived as a potential failure to co-operate or signal concern, provoking further unwelcome scrutiny. However, signing up to an attestation may risk exposure in any future investigation.

An example of the way in which attestations may become relevant in the context of enforcement action is provided by the Rabobank Final Notice published in October 2013 which imposed a fine of £105 million in connection with the manipulation of LIBOR. The FCA found that a March 2011 attestation that Rabobank's LIBOR procedures were fit for purpose was inaccurate and should not have been made as it was. It remains to be seen whether any particular individuals will face enforcement action as a consequence but the decision highlights the care that must be taken when giving attestations.

Attestations should be limited where possible to the carrying out of specific tasks, rather than containing subjective general statements about systems and controls. Senior managers signing attestations should ensure that they can evidence that they have taken all reasonable steps to support the attestation. It may be prudent to create an internal 'attestation pyramid' which records the tasks delegated to more junior members of staff and measures taken by those responsible, including challenge and follow up as appropriate.

The impact of the June 2013 Parliamentary Commission on Banking Standards Report

In June 2013, the Parliamentary Commission on Banking Standards (the 'Commission') published its report, 'Changing banking for good', following an inquiry into professional standards within the UK banking sector (the 'Report'). The Report concluded that many bankers, particularly at senior level, had been allowed to operate with little personal accountability and made recommendations for improving individual accountability in three key areas: (a) framework for individuals; (b) enforcement against individuals and (c) incentives for better behaviours.

Some of the recommendations have now been introduced by the Financial Services (Banking Reform) Act 2013 as follows:

(a) Framework for individuals: Senior Persons and Licencing

For deposit-taking entities, the existing Approved Persons Regime will be replaced by a 'Senior Persons Regime' to ensure that the most important responsibilities within banks are assigned to specific senior individuals

While the details of the new regime require consultation, key features will include individual attestations and the requirement to formally accept a written Statement of Responsibilities to ensure that a named individual is accountable for each key business risk. In addition, a new 'licensing' regime based on a set of individual standards will extend to less senior employees but whose actions or behaviour could seriously harm the bank, its reputation or its customers.

The FCA's current view is that the existing Approved Persons Regime will continue to apply to all non-deposit-taking entities but the Senior Persons Regime will become an 'integral part' of the FCA approach and the FCA will consider whether aspects of the new regime should be incorporated into the existing framework.

(b) Enforcement against individuals: Reckless mismanagement and other changes

A new criminal offence is being introduced for Senior Persons of reckless misconduct in the management of a bank.

The government has also accepted the Commission's recommendations regarding: (i) an extension, in certain circumstances, of the three-year time limit for enforcement action against individuals; and (ii) the reversal of the burden of proof where enforcement action is taken against a bank such that Senior Persons must show that they took all reasonable steps to prevent or mitigate the effects of a specified failing.

(c) Incentives for better behaviour: the Remuneration Code

The Report recommended the introduction of a new statutory remuneration code to better align risks taken and rewards received, as well as a new power to cancel outstanding deferred remuneration for senior bank employees in the event of their employers needing taxpayer support.

The FCA believes that the Commission's proposals can be achieved by adjusting the FSA's 2009 Remuneration Code (the 'Remuneration Code'). The FCA has, however, stated that it supports the Commission's wider recommendations on remuneration, including the development of legal and contractual arrangements to allow deferred remuneration to be recouped in a wider range of circumstances. The FCA intends to work with the Prudential Regulation Authority (the PRA) on these proposals and may consult on any necessary changes to the Remuneration Code in 2014.

The FCA also agrees with the Commission that remuneration, including sales-based incentives, can cause conduct failings. In December 2013 the FCA imposed a fine of over £28 million on Lloyds TSB Bank plc and Bank of Scotland plc in connection with failings in controls over such incentive schemes. Following the publication in January 2013 of guidance on incentives, the FCA is currently conducting follow up work to see if firms are now managing the risks to consumers from sales based incentives and plans to publish the findings in the first quarter of 2014.

Conclusion

Speaking in October 2013, Tracey McDermott, the FCA's Director of Enforcement and Financial Crime, highlighted that in 2012/13, the FCA took action against more individuals than firms imposing £5m in fines, 43 prohibitions and obtaining 13 criminal convictions. At the time of writing, 2013/14 has not yet seen significantly increased fines imposed on high profile individuals for management failings. However, the FCA has said that it will not be deterred by the difficulty of bringing such cases. There have been a number of institutional failures which may yet give rise to individual outcomes and the regime changes being introduced are intended to facilitate the FCA's regulatory objective to hold more managers to account. A clear message is being sent to senior managers that they are now in the regulatory spotlight.

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Civil liability of Credit Rating Agencies

Credit rating agencies ('CRAs') play a crucial role in global securities and banking markets, as their credit ratings are used by market participants to make investment and financing decisions.

Introduction

Prior to the global financial crisis CRAs were not formally regulated in the European Union. Following the financial crisis, however, CRAs became subject to significant regulatory scrutiny.

In 2009 the EU introduced a formal regulatory regime for CRAs. The regime was contained in Regulation (EC) No 1060/2009 (the 'CRA Regulation').

In 2013 a number of reforms to the CRA regulatory regime were introduced by Regulation (EC) No 462/2013. Among other things, Regulation (EC) No 462/2013 established a new civil liability regime for CRAs. The regime, which is contained in a new Article 35a of the CRA Regulation, allows civil claims to be made against CRAs in certain defined scenarios. Article 35a has been implemented in the United Kingdom by the Credit Rating Agencies (Civil Liability) Regulations 2013 (the 'Regulations').

Set out below is a summary of the main elements of the new liability regime. Other aspects of the reforms introduced by Regulation (EC) No 462/2013, such as the rotation of rating agencies for resecuritisations, are outside the scope of this article.

Civil liability regime

The new cause of action

Article 35a(1) of the CRA Regulation provides for civil liability of CRAs in the following terms:

'Where a credit rating agency has committed, intentionally or with gross negligence, any of the infringements listed in Annex III [of the CRA Regulation] having an impact on a credit rating, an investor or issuer may claim damages from that credit rating agency for damage caused to it due to that infringement.

An investor may claim damages under this Article where it establishes that it has reasonably relied ... on a credit rating for a decision to invest into, hold onto or divest from a financial instrument covered by that credit rating.

An issuer may claim damages under this Article where it establishes that it or its financial instruments are covered by that credit rating and the infringement was not caused by misleading and inaccurate information provided by the issuer to the credit rating agency, directly or through information publicly available.'

The most important feature of Article 35a is that it allows relevant market participants to claim compensation from CRAs where there is no contractual relationship or other relationship giving rise to a duty of care between them. In other words, an investor or issuer who suffers loss as a result of a flawed credit rating may claim compensation from the relevant CRA even though there is no proximate relationship between them.

The imposition of liability in the absence of a proximate relationship represents a significant departure from the traditional approach in England and Wales, which has been cautious about permitting claims for economic loss flowing from negligent statements. That caution has been driven by a desire to avoid a flood of claims and to ensure that those who publish information do not face liability which is out of proportion to their culpability, the fee earned or their ability to insure against the consequence of negligence (see for instance *Caparo v Dickman* [1990] 2 A.C. 605). Indeed, expansive liability to market participants has traditionally been resisted on the basis that it would expose defendants to 'liability in an indeterminate amount, for an indeterminate time, to an indeterminate class' (Ultramares Corporation v. Touche (1931) 174 N.E. 441, 444, per Cardozo C.J). Although, in the recent Australian case of Bathurst Regional Council v Local Government Financial Service Pty Ltd (No 5) [2012] FCA 1200, it was held that a CRA, in assigning a rating to a debt instrument, owed a duty of care to potential investors.

It was in recognition of the difficulties associated with establishing civil liability against CRAs that Article 35a was introduced.

Elements of the new cause of action

In order to make out a successful claim under the new civil liability regime, investors who do not have a contractual relationship with the defendant CRA will have to prove that:

- The CRA has committed an infringement of the type listed in Annex III of Regulation (EC) No 1060/2009.
- The infringement was committed intentionally or with gross negligence.
- The infringement had an impact on a credit rating and caused the investor to suffer loss.
- They (the investor) reasonably relied on the relevant credit rating when deciding whether to invest into, hold onto or divest from a financial instrument covered by that credit rating.

These matters are considered briefly below.

Infringement

The types of infringements under Annex III that potentially give rise to civil liability are mainly procedural in nature. There are, however, a range of substantive infringements upon which claimants may rely. For example, the following infringements by CRAs can form the basis of a claim under the new regime:

- Not ensuring rating analysts have appropriate knowledge and experience for the duties assigned (paragraph 1(27) of Annex III).
- not adopting adequate measures to ensure that credit ratings are based on a thorough analysis of all the information that is available (paragraph 1(42) of Annex III).

These substantive breaches are similar in nature to errors that one would expect to find in an ordinary claim for negligence.

Intention/gross negligence

In addition to proving that a CRA has committed a relevant infringement, claimant investors must prove that the infringement was committed by the CRA intentionally or with 'gross negligence'. This is a relatively high threshold.

It is entirely possible that claimants will have difficulty in establishing that relevant infringements took place intentionally or with gross negligence. This is particularly so given the restrictive way in which 'intention' and 'gross negligence' have been defined by the Regulations.

Under the Regulations, an infringement shall be considered to have taken place intentionally or with gross negligence in the following respective circumstances:

'if the senior management of the credit rating agency acted deliberately to commit the infringement'; or

'if the senior management of the credit rating agency were reckless as to whether the infringement occurred'.

The definition of 'gross negligence' is further restricted by paragraph 4(2) of the Regulations, which states that for the purposes of the Regulations, the senior management of a credit rating agency are reckless '*if they act without caring whether an infringement occurs*'. This definition is similar to the test for subjective recklessness.

The upshot of the above tests for 'intention' and 'gross negligence' is that claimant investors will not be able to establish liability under the new regime simply by showing that an infringement occurred by mistake or by reason of a failure to take reasonable care. It will be necessary to persuade a court that relevant infringements were committed deliberately by senior management or, alternatively, that senior management were subjectively reckless regarding whether the relevant infringement occurred.

Causation

In order to make out a claim, investors will also have to show that the relevant infringement had an impact on the CRA's credit rating (i.e. that the infringement resulted in a different rating category being assigned to the issuer or the financial instrument of the issuer to which the credit rating relates) and that the infringement caused them to suffer damage.

The test for causation under the new liability regime will be the same as the test used in negligence claims. In other words, causation will be established by applying the 'but for' test. Claimants will need to show that but for the CRA's relevant infringement they would have been better off.

The defendant CRA will have a good defence if it can establish that the infringement did not cause the investor to suffer loss. In other words, CRAs will be able to escape liability if they can persuade the court that:

- Even if a proper rating had been given, the claimant would have been no better off.
- The way in which the claimant says he would have acted in an infringement-free context would not have conferred on him the benefits for which he seeks compensation.

Questions of causation are often fact sensitive and the success of CRAs in deploying causation defences will very much depend on the evidence presented to the court.

Reasonable reliance

The final hurdle that claimant investors must overcome relates to 'reasonable reliance'. It must be shown that the claimant investor 'reasonably relied' upon the CRA's credit rating when making its investment decision.

Whether an investor's reliance on a credit rating was reasonable will depend upon the facts of each case. However, a clue as to the circumstances in which reliance on a rating will not be reasonable is given by Article 5a(1) of the CRA Regulation. Article 5a(1), which is applicable to commercial market participants such as credit institutions, investment firms and insurance/reinsurance undertakings, requires such entities to make their own credit risk assessment and prohibits them from solely or mechanistically relying on credit ratings for assessing the creditworthiness of an entity or financial instrument. It is therefore likely that commercial entities which fail to assess their investments independently, and instead rely mechanically on CRA ratings, may well have difficulty in making out a claim under Article 35a.

In order to make out a successful claim private investors must also take due care with their investment decisions, i.e. take the care a reasonably prudent investor would have exercised in the circumstances. The extent to which the 'due care' test requires private investors to conduct their own credit risk assessment, and the nature of those risk assessments, is currently unclear and is likely to be a key area of debate in future claims made under the new regime.

Conclusion

Article 35a was implemented because of concerns that investors did not have an effective right of redress against CRAs if they suffered loss as a consequence of a flawed rating.

The new liability regime provides such a system of redress and thereby creates significant additional litigation risks for CRAs. The precise extent of those litigation risks, however, is not yet entirely clear. For example, section 14 of the Regulations provides that where there is no contract between the CRA and claimant investor, the damages recoverable by the investor are to be calculated on the same basis as if the claimant had succeeded against the CRA in a claim for negligence. While section 14 makes it clear that principles such as mitigation and remoteness may serve to reduce the damages payable by CRAs, it is not entirely clear whether (and to what extent) other common law principles may serve to limit the damages payable by CRAs. The extent to which CRAs may limit their liability using the principle that recovery is limited to the difference between the value the CRA attributed to the investment and the true value of that investment (known as the 'SAAMCO cap' after *Banque Bruxelles Lambert v Eagle Star* (SAAMCo) [1996] UKHL 10), for example, may well have to be determined by a court.

Also, the Regulations permit CRAs expressly to limit their liability, provided that such limitation is 'reasonable and proportionate'. Sections 10-12 of the Regulations set out specific factors that are relevant to determining whether a limitation is reasonable and proportionate. However, the application of this test is likely to be highly fact dependant and it is another area where the courts may be asked to give clarification.

Given the entirely new risks presented by Article 35a, and the inevitable uncertainties associated with new claims based on that Article, CRAs will have to give careful consideration to their current risk management procedures and the potential liabilities they may incur under the new civil liability regime.

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Increased focus on financial institutions in recent US FCPA matters

Following the public outcry over corporate misconduct that contributed to the 2008 financial crisis, US authorities' increased their scrutiny of the financial sector.

Introduction

The most recent US Foreign Corrupt Practices Act ('FCPA') enforcement actions taken by the Securities and Exchange Commission ('SEC') and the Department of Justice ('DOJ') suggest that anti-corruption enforcement is no exception to this development. The trends seen in recent enforcement actions related to financial institutions, private equity firms, and other businesses operating in this sector indicate that, unlike many issues in the financial sector which are notoriously difficult to regulate and currently the subject of evolving standards and strategies for enforcement, the DOJ and the SEC have been able to successfully apply existing anti-corruption standards and strategies in this area to effectuate their enforcement goals. Moreover, the SEC's continued allowance of FCPA settlements where companies neither admit nor deny misconduct shows that this is also an area where financial institutions can successfully mitigate their exposure through the implementation of effective compliance programs and the quick investigation and remediation of problems that arise.

Recent US FCPA enforcement activities relating to financial institutions

Corporate Settlement: Diebold, Inc.

On October 22, 2013, the SEC and the DOJ charged Diebold, Inc., ('Diebold') an Ohio-based manufacturer of ATMs and bank security systems, with violating the FCPA by allegedly bribing officials at government owned and privately owned banks in China, Indonesia, and Russia. According to the SEC complaint, between 2005 and 2010, Diebold, through its agents and subsidiaries, bribed government officials in China and Indonesia by providing extravagant international trips, entertainment, and gifts to foreign officials to obtain or retain business with government owned banks. During that same time period, Diebold allegedly channeled bribes to privately held banks in Russia by creating and entering into false contracts with a distributor in Russia for services that the distributor was not performing. The distributor then purportedly passed the money along to employees at privately-held banks for whom Diebold provided ATMs. The enforcement action involved an SEC civil complaint, which Diebold settled without admitting or denying the allegations, and a criminal information against Diebold, which was resolved through a deferred prosecution agreement. Ultimately, Diebold agreed to pay $48.1 million to settle the parallel enforcement actions and agreed to retain a compliance officer for at least 18 months.

Settlements with Individuals: Ernesto Lujan, Jose Alejandro Hurtado and Tomas Alberto Clarke Bethancourt (BANDES Prosecution)

On August 30, 2013, Ernesto Lujan, Jose Alejandro Hurtado and Tomas Alberto Clarke Bethancourt, all three former US broker-dealers for Direct Access Partners, LLP, pled guilty in the Southern District of New York to conspiring to violate the FCPA, to violate the Travel Act, and to commit money laundering as well as to substantive violations of these offenses. These charges are based on a scheme to bribe a foreign official at a state economic development bank in Venezuela ('BANDES') in exchange for receiving trading business. Based on this scheme, the former broker-dealers made over $60 million in commissions. The broker-dealers then used these commissions to funnel kickback payments to the government official at BANDES. Three months later, on November 18, 2013, the government official at BANDES, Maria De Los Angeles Gonzalez De Hernandez, pled guilty to conspiracy to violate and substantive violations of the Travel Act and anti-money laundering laws in the Southern District of New York for her involvement in the scheme involving the broker-dealers. Ms. Hernandez admitted receiving millions of dollars in kickbacks from the Direct Access Partners dealers.

Investigative initiative: Sovereign Wealth Funds

In January 2011, the SEC issued letters to ten financial institutions and private equity firms concerning these institutions' relationships with Sovereign Wealth Funds ('SWFs'). SWFs are global investment funds created, owned, and controlled by foreign governments. It is unclear what conduct was at issue, but such conduct could have included the companies' solicitation of business or solicitation of investment by the SWFs. The FCPA defense community continues to debate whether the FCPA applies to SWFs, but this is an area of risk that financial institutions should consider.

Enforcement trends

These recent actions reflect several trends that mirror and build upon enforcement strategies that have been used in other industries over the last several years and were discussed by the authorities in their November 2012 *A Resource Guide to the Foreign Corrupt Practices Act* ('Guidance') and other policy statements.

Solicitation of business and third parties

The two most recent enforcement actions dealing with the financial industry—the Diebold settlement and the BANDES prosecution—dealt with the traditional US FCPA concern of obtaining or retaining business through bribery and the use of third parties to make illicit payments. The individuals in the BANDES prosecution pocketed millions of dollars in commissions based on unlawful payments to the BANDES official who in return directed trading business to the broker-dealers. Diebold allegedly made unlawful payments to both state-owned and privately owned banks to secure contracts to sell ATMs and bank security systems.

Sovereign Wealth Funds as 'government instrumentalities'

The SEC and the DOJ's focus on financial institutions' transactions with SWFs highlights a type of high risk party that should trigger heightened compliance requirements and education. Based on the letters issued by the SEC, it appears that the US authorities view SWFs as governmental entities and SWF employees as government officials under the FCPA because the SWFs are owned and operated by foreign governments. While the DOJ and SEC have yet to resolve an enforcement action against any firm for FCPA violations in this area, a number of these investigations into companies' relationships to SWFs are ongoing.

Commercial bribery

The recent settlement with Diebold suggests that business entities will be held liable if they commit private, commercial bribery. While the FCPA anti-bribery provision does not explicitly address private bribery, the DOJ and the SEC have previously discussed their willingness to prosecute private commercial bribery under the FCPA's accounting provisions, the Travel Act, and anti-money laundering laws. The recent Diebold case suggests that the US enforcement authorities may be following through on their prior statements and extending their enforcement efforts to bribery of private entities. According to the SEC complaint, Diebold allegedly violated the FCPA when it falsely recorded bribes made to privately held banks in Russia in the company's books and records as legitimate business expenses.

No admit no deny agreements

In spite of the SEC's announcement on 18 June 2013 that it would begin seeking admissions, rather than allowing companies to settle while neither admitting nor denying misconduct, so far the SEC has not sought an admission in an FCPA case. Before this announcement, the SEC had a blanket policy of allowing companies to pay fines and disgorge profits to settle enforcement actions without admitting or denying any wrongdoing except where the company was convicted of criminal charges based on the same conduct. This tool allowed companies to settle the actions against them without providing additional evidence to support criminal or other civil liability. However, the SEC emphasized at the time of the announcement that allowing companies to settle without admitting or denying would continue to be a common tool, and that the cases where it would seek an admission might include:

- 'Misconduct that harmed large numbers of investors or placed investors or the market at risk of potentially serious harm.'
- 'Where admissions might safeguard against risks posed by the defendant to the investing public, particularly when the defendant engaged in egregious intentional misconduct.'
- 'When the defendant engaged in unlawful obstruction of the commission's investigative processes.'

That FCPA cases have continued to be settled on a no admit no deny basis suggests that in this area, the compliance norms and remediation practices that have become standard over the last several years may serve to prevent FCPA matters from falling into one of the categories, which might lead the SEC to seek an admission.

Conclusion

To mitigate exposure posed by the US anti-corruption authorities continued focus on the financial sector, financial institutions and other companies doing business in that space should both ensure that they have an effective compliance program in place and that they continually update and tailor their compliance programs to meet the evolving enforcement initiatives and trends in corruption related misconduct.

Preventing bribery in the solicitation of business
Financial sector entities should ensure they have robust compliance policies and procedures governing interactions with government officials and other individuals for the purpose of obtaining business. These policies should include restrictions on providing meals, gifts, entertainment, and travel to government officials and customers as well as a prohibition on cash payments.

Dealing with third parties and high-risk business partners
Companies and financial institutions have an obligation to know the parties with whom they do business and ensure that they do not engage in bribery. Compliance programs should include a policy and set of procedures for due-diligence on third parties and other business partners, and companies should require contracts with third parties and business partners that contain anti-corruption representations and warranties as well as FCPA training and certification requirements.

Relationships with sovereign wealth funds
Financial institutions and other businesses operating in this space must make clear in their compliance policies that Sovereign Wealth Funds are governmental entities and thus their employees are considered government officials for the purposes of the FCPA. While standard FCPA policies and procedures will likely protect against corruption problems when the relationship involves the solicitation of business from SWFs or entering into an investment partnership with such entities, companies need to be aware that SWFs may be considered to be government entities and their employees may be considered government officials under the FCPA, and they should develop policies and procedures that will deal with the solicitation of investment from these funds.

Staying in the no admit no deny space
As the SEC begins to exercise this new policy, financial institutions and other companies should fortify the aspects of the compliance program that will prevent problems that arise from falling into one of the SEC's identified categories, such as consistent application of the compliance program, appropriate tone at the top, strong internal controls, books and records policies that will prevent conduct from being covered up, incentivizing employees to comply and report, quick investigation of problems that arise, and timely and adequate remediation including removal or termination of employees that engaged in misconduct.

Commercial bribery
Companies should ensure that their compliance programs extend to interactions with private entities as well as government officials and that books and records requirements apply to all transactions.

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Banking and finance disputes: an insurance perspective

As the scope of this publication shows, the flow of litigation involving financial institutions and their senior managers shows no sign of abating. It is also clear that, for the foreseeable future, the financial sector will continue to be the subject of intense regulatory scrutiny. In such an environment, the availability of insurance to meet liabilities as they arise takes on greater significance. For a financial institution ("FI") faced with mis-selling claims as in *Graiseley Properties v Barclays Bank* [2013] EWHC 67 (Comm), or with the possibility of a lengthy and expensive regulatory investigation, it will be important to know which liabilities and costs insurers will meet.

LIBOR fixing

As a result of the Court of Appeal's judgment in *Graiseley*, the claimants in that case may now introduce new allegations of deceit relating to the manipulation of LIBOR. This potentially raises questions as to what senior management may have known at the relevant time, with the defendant now facing claims based on dishonesty, as well as non-fraudulent misrepresentation. If this provides a template for future LIBOR-related claims against FIs and their directors, will their liabilities be covered?

From the FI's point of view, its professional indemnity ("PI") insurance policy is the policy which is most likely to meet liabilities connected with the sale of products linked to LIBOR. Typically, this type of policy provides cover for claims made against the insured arising out of any "Wrongful Act", meaning (in summary) any error in the performance of the professional services which it provides. However, while liabilities of this type may appear to fall within the scope of PI policies, a number of market standard exclusions may be relevant. Most obviously, PI policies often exclude cover for losses on account of claims for acts of "market abuse". The usual exclusion for dishonest or fraudulent acts may also apply to preclude cover.

From the directors' point of view, the FI's directors & officers ("D&O") insurance policy is most likely to respond, whether it indemnifies the insured director (Side A) or reimburses the FI (Side B). If the scale of LIBOR mis-selling claims is such that the FI's share price falls, derivative claims against its directors are possible. In this situation, the FI's D&O policy may provide cover to directors for their liabilities and defence costs, which are generally advanced pending final resolution of the claim. Likewise, individual directors may be the target of other civil (or even criminal) claims – although cover will be withdrawn if fraud is established, at which point defence costs which have been advanced will become repayable.

Financial intermediary liability

In *Forsta AP-Fonden v Bank of New York Mellon* [2013] EWHC 3127 (Comm), the Bank of New York Mellon ("BONY") was found to have failed to inform Forsta AP-Fonden ("Forsta") that there was a serious risk of loss associated with securities for which it acted as custodian. This failure to inform was found to constitute a negligent misrepresentation, as well as a breach of its contractual and common law duty of care. On this basis, BONY was held liable to Forsta for its losses resulting from the decline in value of the securities. Although the outcome was different in *Torre Asset Funding v RBS* [2013] EWHC 2670 (Ch), the basis for Torre Asset Funding Limited's ("Torre") claim was similar to *Forsta*, being the alleged failure of the agent, Royal Bank of Scotland Plc ("RBS"), to inform Torre of discussions constituting an event of default. Such failure was said to constitute a breach of RBS's contractual duties as agent.

While coverage would depend on the wording of the policy, liabilities of the type incurred by BONY and RBS (as regards defence costs) would most naturally fall to be considered under a FI's PI policy. This is because breaches of duty of the type alleged in both cases would be likely to fall within the definition of Wrongful Act, as summarised above. However, cover might be denied if there is an exclusion for losses arising from a breach of duty that exists solely under contract. In certain circumstances, the application of this common exclusion can be the subject of debate concerning the basis of the insured FI's liability. While the position in *Torre* would seem more clear-cut in terms of the likely policy response, given the Court's findings in relation to breach of duty, it may not be the same in all cases. Compare, for instance, *Green & Rowley v Royal Bank of Scotland Plc* [2013] EWCA Civ 1197 where, in a mis-selling context, the Court of Appeal confirmed that a common law duty of care did not arise concurrently with RBS's obligations under s.138D of FSMA.

Investment performance

And what of those mis-selling claims where the FI is sued for recommending an investment on which a loss is then incurred? In such cases, an interesting question can arise – do representations as to the risk of the investment amount to an express guarantee or warranty of its performance? For example, the original pleading in *Al Suleiman v Credit Suisse Securities (Europe) Limited* [2013] EWHC 400 (Comm) featured a claim based on an alleged representation that the notes in question involved "very little risk". Although this allegation had been abandoned by the time of trial, losses connected with representations of this type are generally excluded under PI policies arranged for FIs.

Defence costs

Notwithstanding *Rubenstein v HSBC Bank* [2012] EWCA Civ 1184, in many cases losses arising from the global financial crisis are too remote to be recoverable (see *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd* [2012] EWHC 7 (Comm)).

However, where the defence is successful, legal costs may not, in fact, be covered under the FI's PI policy.

This is a topical issue in insurance law circles following the Court of Appeal's decision in *AstraZeneca v XL Insurance* [2013] EWCA Civ 1660. In that case, the Court of Appeal confirmed that, because of the way in which the policy had been drafted, the policyholder could not recover its costs of successfully defending the claim, even though costs would have been recoverable if liability had been established. Following this decision, FIs would therefore be well-advised to review their PI policy wordings to avoid any possibility of what is, in the Court of Appeal's words, a *"surprising"* and *"profoundly unsatisfactory"* outcome.

Investigation costs, fines and penalties

Legal costs associated with regulatory investigations can be, and often are, very significant.

For the FI, costs relating to an investigation into its affairs may be covered under its PI policy, possibly via an extension. However, the scope of such cover does not generally extend to financial industry reviews and may also not include the cost of engaging a skilled person to produce a report under Section 166 of FMSA. Particular attention should also be paid to the definition of "Investigation Costs", or the equivalent term used in the policy, which may be ambiguous as to whether certain advisory costs are covered. For FIs calculating their exposure to regulatory examination as a result of LIBOR fixing allegations, the limitations of their insurance cover for such costs will need to be considered carefully. As for fines and penalties which may be imposed by a regulator, these are unlikely to be indemnifiable as a matter of English law and are likely to be excluded by the policy in any event. The same applies to FIs investigated for bribery – note that claims relating to profit to which the FI is not entitled are commonly excluded.

For directors requiring representation, perhaps in relation to a LIBOR regulatory investigation, their costs are likely to be met by the FI's D&O policy. In connection with the scope of this indemnity, the same considerations arise as are discussed above in relation to the civil liability of directors for LIBOR-related mis-selling, as well as fines and penalties.

Conclusion

PI and D&O policies are the types of policy most likely to be relevant to cases arising out of the global financial crisis, but it is also worth considering the scope of cover under other types of policy, such as Bankers Blanket Bond, which provides cover for an FI's own ('first party') losses. It is also clear that, while the liability of FIs for losses incurred by clients and other third parties may fall within the scope of PI and D&O policies, the scope and operation of exclusions will be critical.

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Spotlight: global regulation and investigations

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