There's a new sheriff in town

The Libor scandal fundamentally changed global regulatory enforcement. Today, institutions are increasingly being deputised to police themselves

Traditionally, when a new sheriff rides into town, the place is in a mess. Society has broken down, lawlessness abounds and right-thinking people avoid the streets. The saloon bars are full of rowdy, intimidating gunslingers who go unchallenged – other than by fellow gunslingers. The town badly needs redemption (as does the sheriff, on occasion). The townspeople bestow a clear mandate for change on their new law officer. He in turn enlists the support of deputies to clean the place up. Vigorous law enforcement takes centre stage.

This approach seems to have been adopted by regulators in the wake of the Libor [London Interbank Offered Rate] scandal. In the post-Libor world, they have effectively deputised firms to pursue their enforcement objectives. A combination of structural changes to law and regulation, and the practicalities surrounding international regulatory investigations, have led to the internalisation of enforcement type activity within firms.

The tipping point

The Libor scandal represented a tipping point in the evolution of modern regulatory enforcement. It exhibited Malcolm Gladwell's three characteristics: contagiousness; the fact that otherwise limited causes or incidents can have big effects; and the fact that change happens not gradually but in one dramatic moment or period.

Libor was the touchpaper that led to an explosion of public and political outrage at the financial services industry that had previously found some expression in the wake of the financial crisis, but had still remained somewhat latent. That explosion led not only to new laws and regulations, but more fundamentally to a renewed empowerment of global regulators.

Further empowered, the regulators have generated significant momentum in re-balancing their relationships with firms. In certain cases, this involved a rehabilitation of the regulators themselves, some of whom were perceived to have been insufficiently aggressive in pursuing enforcement options in the lead up to and during the financial crisis. In December 2008, the Madoff scandal would raise questions about whether the Securities and Exchange Commission (SEC) had been overly light touch in its approach. In March 2009, Hector Sants, then chief executive of the UK Financial Services Authority (FSA), felt compelled to announce the end of light touch regulation by the regulator, with his memorable declaration: "People should be very frightened of the FSA".

Most significantly for the future, Libor marked a paradigm shift in the nature, international scope and intrusiveness of regulatory enforcement activity. Both in practice, and as a matter of law, institutions are increasingly being deputised by the sheriff to police themselves across the world, identify responsible individuals for future enforcement purposes, attest to controls, and disprove guilt (as opposed to defending innocence) when a problem arises.

The result is a once-in-a-generation imperative on senior business, compliance and legal management to implement not only major systems and controls changes, but fundamental cultural change, before the next big scandal. Institutions will have to be able to demonstrate that they can police the town vigorously, including finding and shooting the gunslingers, if they are not to be in the sheriff's sights themselves.

Libor: origins and outcomes

Libor was a child born of the financial crisis. In April 2008, bank analysts issued a research note concluding that 'the current liquidity crisis has damaged the interbank market, resulting in Libor sets that at times deviate significantly from real interbank lending rates'. It also stated, rather prophetically, that if Libor lost credibility 'the long-term psychological and economic impacts this could have on the financial markets are incalculable'.

By May 2008, despite the British Bankers Association's (BBA) expression of 'every confidence in the integrity of the BBA Libor setting process and the accuracy of the figures it produces', journalists at Bloomberg and the WSJ were highlighting the issue. Regulators, notably the US Commodities Futures Trading Commission (CFTC) were to start investigating shortly thereafter. That investigation was to have something of a long lead time, however, because it was not until 2012 that the reach and scale of the investigation were to become widely publicised.

On June 27 2012, Barclays received the then largest-ever fine imposed by the FSA of £59.5 million ($87.7 million), as part of a settlement with US and UK regulators for $453 million. Barclays also lost its chief executive, Bob Diamond. The Barclays fine was soon eclipsed by the new largest-ever FSA fine meted out to UBS on December 19 2012, as part of a $1.5 billion settlement with UK, US and Swiss regulators. Two months later, on February 6 2013, RBS was fined £87.5 million as part of a global settlement of $612 million. In late 2013, Rabobank was fined $1.07 billion. In July 2014, Lloyds Bank was fined $370 million.

Just over a year later, on November 11 2014, the Financial Conduct Authority (FCA) imposed fines totalling £1.1 billion on five banks, for failing to control business practices and maintain proper systems and controls in the banks' foreign exchange (FX) trading activities between 2008 and 2013.

Quite apart from their eye-watering size, these fines and the subsequent legislative follow-up changed the enforcement landscape altogether.

Lessons for enforcers and the enforced

A number of key lessons have emerged from that dramatic period.

Libor as the first global investigation – opportunities and challenges

Libor became the first truly global financial investigation, despite its initially limited scope. At its height, Libor or related benchmarks were being investigated by at least 12 regulators around the world. These included financial and competition regulators in the US (CFTC, SEC, Department of Justice (DoJ)), the UK (FCA and Serious Fraud Office), Germany (BaFin), Switzerland (Swiss Comco), the European Commission, Korea Fair Trade Commission, Hong Kong Monetary Authority, Monetary Authority of Singapore and Japan Financial Services Agency. The FX investigation was to follow suit in a very similar fashion.

This profusion of international overseers presented firms and regulators with a novel, complex, and not always harmonious relationship dynamic.

On the face of it, answering questions or providing information to multiple regulators might have given rise to logistical issues in the past, but these were relatively easily navigable. A US regulator seeking information from a UK firm would generally make a request for documents through the international cooperation section of the FCA. The UK regulator would duly pass on the request in the form of a Notice of Requirement to the firm, exercising statutory powers of compulsion that disposed of Data Protection Act issues while requiring production.

By contrast, following the spaghetti-like trail of global business lines and responsibilities, employees moving from country to country with their work, and the other cross-border aspects of Libor gave rise to difficult – and occasionally delicate – problems for regulators and firms alike.

In the context of their international reach, Libor highlighted the limitations on the territorial jurisdiction of regulators. Given their own statutory and other restrictions, not to mention comity and sovereign authority issues with other regulators, they could not simply march into another country to follow the trail inevitably laid by international banks operating in international markets.

The Libor scandal represented a tipping point in the evolution of modern regulatory enforcement

These limitations would try the patience of regulators. One solution for the sheriffs, in addition to using formal channels, was to deputise firms to secure documents and evidence from other jurisdictions as well as their home, and produce these in the home regulator's jurisdiction.

At a stroke, regulators were effectively able to travel around the world through the eyes and ears of the bank's internal legal, risk and compliance functions, and external advisors. They could see things that would historically have been available only through a more formal and lengthy mutual cooperation structure, if at all.

This is not to suggest that regulators simply delegated their investigations to firms. Far from it. The deputisation was designed to supplement, not supplant, regulators' efforts. This was explained by principle deputy assistant attorney general Marshall Miller of the DoJ in a speech at the GIR Programme in New York on September 17 2014:

"Some years ago there was a perception that the Justice Department outsourced investigations of corporate criminal conduct to private law firms then sat back and waited for presentations and memos and hot docs to roll in. At the Criminal Division, nothing could be further from the truth".

Miller was emphatic, as any fellow regulator would be, that while the DoJ strongly encourages cooperation and firms to carry out their own investigations, these are just one of the many tools that are used to further investigations. They do not rely on the internal investigation to make their case.

A bobby on the beat

Similarly, and echoing comments made by FCA Enforcement in December 2014, Andrew Ceresney, director of the SEC's Enforcement Division, made the point at a Corporate Governance conference on February 10 2015: "It is obviously an active regulatory atmosphere, we think it is important for investors to have an active cop on the beat who is looking for misconduct".

The extent to which regulators may use or depend on a firm's own investigation will, in any event, depend to a large extent on the objectivity, rigour and thoroughness with which the firm and its advisors are perceived to have conducted that investigation.

The relationship between regulators has not always worked smoothly. Certain regulators in the US, Europe and Asia are notoriously jealous of their own sovereignty and priority, with the result that firms can be placed in an invidious position, trying to intermediate between the competing and conflicting demands of regulators. One regulator might, for example, insist on seeing all materials being shown to other regulators (although some regulators positively avoid the potential death-by-information this might involve). Another regulator would insist on strict confidentiality of its dealings with a firm – not only as regards other third parties such as overseas regulators, but even within a firm or its legal advisors. Resolving such issues requires Bismarckian diplomacy.

A further issue when a firm is deputised in this way is the lack of clarity as to parallel lines of communication between regulators, and the risks to which this gives rise. While the UK, US, Swiss and other regulators will proudly announce their close cross-border cooperation at the time of settlements, it is rare in practice to obtain any real insight into levels of collaboration, including what is or is not being shared during the course of an investigation, prior to the settlement.

It can be dangerous to make any assumptions in this context, for example that regulators are discussing matters at regulatory colleges or will generally pass on material information in a timely and comprehensive manner as between themselves. Reasonable as it may be, if that assumption proves wrong, and the regulators perceive a failure of openness or cooperation by the firm in providing such information under principle 11 of the FCA's Principles for Businesses in the UK, or its equivalent elsewhere, the consequences can be severe. Goldman Sachs found this out when it was fined £17.5 million in September 2010 by the FSA for breach of principle 11, among others, for its failure to keep the FSA informed of material developments in a non-Libor SEC investigation.

Further, the manner in which these deputised investigations are reported back to regulators can cause serious issues. In the US, it is commonly accepted practice that this process will be undertaken orally in the interlocutory stages, rather than in writing. This is because the opening question that any plaintiff's counsel suing a firm will ask in their first discovery request is for copies of all documents provided to or shared with the regulator, including reports. The spectre of massive private class action litigation in the background is such a significant feature in the US that regulators are broadly sympathetic to such concerns provided that they obtain the information that they need for their purposes.

This has historically not been the position in the UK, because litigation does not tend to follow regulatory enforcement in the same way. Regulators have therefore tended to be less sensitive to the issue. That may change. At the outset of the FX inquiry, the FCA's proposal that firms be required to follow its so-called interview protocol led to widespread and considerable disquiet across the London market. Firms were concerned about its impact on the protection of legal professional privilege, as well as its interaction with compulsion and other powers under the Financial Services and Markets Act 2000.

Legislative changes

The transparency engendered by this tendency towards investigation by proxy will be enhanced by imminent legislative changes to the UK regulatory environment. Speaking in December 2014, Tracey McDermott, director of enforcement and financial crime at the FCA, observed:

"There is now an even greater determination at the FCA to make clear to those at the top of firms that by accepting their jobs, and the rewards that come with them, they take on personal accountability … Importantly, the new senior managers regime for banks will require firms to certify their own staff – they will be forced to take responsibility for fitness and propriety of those they employ, rather than expecting the regulator to do that for them".

"Libor became the first truly global financial investigation

The internalisation of the enforcement agenda is being accelerated by statutory measures to be introduced under the Financial Services (Banking Reform) Act 2013, which followed the high profile inquiry and recommendations of the UK Parliamentary Commission on Banking Standards. These measures are the subject of pre-implementation consideration by UK regulators; near-final rules were published by the FSA for consultation purposes on March 16 2015. They will come into force by March 7 2016. They include the new Senior Managers Regime, whereby senior management will have to accept a so-called statement of responsibilities. A requirement to prepare a handover certificate for future reference when changing roles is also expected.

These measures provide a backdrop to the more radical change introduced under the statute, which is designed to demolish what was described by the Parliamentary Commission as the 'accountability firewall' within firms, where the chain of responsibility always appeared to the Commission to stop before reaching the top of firms. (This is not a new concern on the part of regulators. Senior management accountability was at the top of the regulatory agenda as regulators confronted their inability to deal with such issues following the Barings/Nick Leeson scandal 20 years ago, in 1995).

This change will see a senior person being held guilty of misconduct for a contravention in their area of responsibility, unless they can show that they took reasonable steps to prevent or avoid the contravention occurring or continuing. The manager will therefore be guilty until proven innocent.

These measures will provide an enforcement lightning rod into firms, and up to their top ranks. They will provide regulators with greater insight into a firm's internal workings and simpler audit trails for regulators to follow. This, in turn, will provide added incentive for internal enforcement-style approaches to be taken when dealing with potential or actual contraventions. If those with power and authority in the firm cannot deal with gunslingers or control failings, they will find themselves the targets for the sheriff.

Although less likely in practice to be of concern, since it retains the conventional burden of proof and other criminal law requirements, the new offence of reckless misconduct leading to the insolvency of a bank – with a maximum seven years imprisonment – will also sharpen the focus of internal discussions and behaviour.

In practice, the distinction between internalised enforcement and what Hector Sants called the "intensive supervisory model" in 2009, is shrinking even further.

Pouring petrol on the fire – the advent of competition-related enforcement in the financial sector

One of the most notable features of the Libor scandal has been the involvement of competition enforcement regulators in a way that has never been seen before in the financial sector. This feature has not simply fanned the flames of such investigations, but has poured petrol on the fire, incentivising even greater internal enforcement focus.

This is because the rules and policies governing competition inquiries incentivise confessional self-reporting in the form of immunity or leniency applications, which in essence provide that the first member of the cartel can obtain immunity from prosecution or fines, or at least leniency, in return for notifying the alleged cartel and providing complete cooperation. Subsequent alleged cartelists can also benefit from discounts.

Under the provisions of the European Commission's current Leniency Notice published in 2006, the DoJ antitrust division leniency programme dating back to 1978, and equivalent measures in other jurisdictions, the competition authorities can commute sanctions. But in all cases, this must be done strictly on the basis that firms provide timely and comprehensive statements about the alleged anti-competitive arrangements, evidence of their own and other's involvement, and continued full cooperation.

This has resulted in a new dynamic. Institutions that would previously have considered and investigated their own conduct, and then privately shared it with a financial regulator, will increasingly feel compelled to engage in a foot race to the competition regulator to obtain immunity or leniency. As the DoJ notes in its own leniency programme, this difference can depend on a matter of hours as between one immunity/leniency applicant or another revealing itself – and all possible colluders – to the relevant competition authorities. The difference in outcome, as was the case in Libor, can be measured in the hundreds of millions or even billions of dollars. Barclays reportedly avoided a €690 million ($724 million) fine as the immunity applicant in Euribor [Euro Interbank Offered Rate]. UBS achieved a breathtaking €2.5 billion saving as the immunity applicant in relation to yen Libor.

This major structural incentive for firms effectively to prosecute themselves (which may be reinforced by the FCA's new competition powers) means that from the institution's perspective, potential problems will surface in a far more rapid and uncontrolled fashion than was ever the case before. It will also lead to increased transparency and insight for regulators, because they will have access not only to a body of material in another institution that they would not have previously had, but that other institution will be singularly motivated to hand over everything it can to the regulator to comply with the conditions for immunity or leniency.

The combined effect of these features of the Libor investigation has been significant. Regulators can not only see inside a firm laparoscopically, but they also can increasingly guide and direct firms remotely, requiring the firm to pursue inquiries and investigations elsewhere in the world. Regulators can also rely on the fact that firms will have every incentive – whether for competition or financial regulatory reasons – to flush out any wrongdoing with the utmost vigour, and with no expense spared, to avoid facing even more serious sanctions themselves.

There is indeed a new sheriff in town. It's you.

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