CLIENT UPDATE

NEW UK CRIMINAL OFFENCES AND REGULATORY CHANGES RELATING TO FINANCIAL SERVICES

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On 1 April 2013, the new criminal offence of taking misleading actions in connection with financial benchmarks came into effect.[1] The UK's financial regulatory rulebook has now been amended to include a new section on the supervision of activities connected with the administration and submission of benchmark information. These measures are the UK's legislative and regulatory response to the so-called "Libor Scandal".

Libor, which is short for the London Interbank Offered Rate, is a key average interest rate of indicated inter-bank lending, forming the basis both of financial products with a nominal value of more than $494 trillion[2] and of innumerable independent contractual commitments. The Libor rate is set on the basis of daily submissions by a number of banks ("Libor panel firms") which are members of the British Bankers' Association, a private self-regulated body ("BBA"). It has emerged that on numerous occasions since 2005, and perhaps earlier, employees of Libor panel firms have submitted

1 Section 91, Financial Services Act 2012. Two new offences—making misleading statements and making misleading impressions have replaced the legacy offence found in section 397 of the Financial Services and Markets Act 2000 effective 1 April 2013.

2 Table 19: Amounts outstanding of over-the-counter ("OTC") derivatives, Semiannual OTC derivatives statistics at end-June 2012, Bank of International Settlements, 13 November 2012.

rates that they knew were incorrect in order to win advantages for themselves or for positions held on behalf of others.[3]

There has been global investigation and punishment of this practice. The UK's Financial Services Authority ("FSA") and the US's Commodity Futures Trading Commission and Department of Justice have levied fines exceeding $2.5 billion on three large international banks, including UK-registered Barclays plc and the Royal Bank of Scotland plc. The UK's Serious Fraud Office ("SFO") is also investigating the matter and arrested a number of traders and brokers in December 2012.[4]

Though the Director of the SFO has stated that existing criminal offences are suitable for the prosecution of wrongdoing connected with the Libor Scandal, the creation of a specific criminal offence to punish such manipulation was recommended by the then chief executive of the FSA, Martin Wheatley, who conducted a public consultation into the matter ("Wheatley Review"). He made 10 recommendations, including changes to the rulebook, transferring responsibility for Libor away from the BBA to a new administrator, and making the submission and administration of Libor a more transparent and accountable process.[5] The UK Government has accepted his recommendations.

MISLEADING ACTIONS IN RELATION TO BENCHMARKS

Section 91 of the Financial Services Act 2012 ("FSA 2012") creates the new offence of "*misleading statements etc in relation to benchmarks*". The Wheatley review recommended that such an offence was necessary "*as any attempts to manipulate LIBOR constitute sufficiently serious conduct to merit this being a criminal offence [with] this conduct…likely to occur in full awareness of the potentially serious and wide ranging impact that manipulation of LIBOR may have in light of its global use*".

The offence criminalises making misleading statements or misleading impressions, or carrying out any course of conduct, in connection with the setting of a relevant benchmark. The broad offence draws upon language found in section 397[6] of the Financial Services and Markets Act 2000 ("FSMA 2000"), and is intended to cover the gamut of benchmark manipulations scenarios. The offence criminalises: (a) any person who knowingly or recklessly makes a false or misleading statement to another with the intention that the

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3 For example, UBS AG was found to have breached the FSA's requirements from 1 January 2005.

4 http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2012/libor--three-arrested-.aspx

5 http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf

6 Section 397, FSMA 2000 is now repealed as part of the amendments to misleading statements and misleading practices.

statement is used for setting a relevant benchmark; and (b) any person who, by a course of conduct, intends to, and knowingly or recklessly does, create a false or misleading impression as to the price of any investment or transaction with an interest rate that may affect the setting of a relevant benchmark.

A "relevant benchmark" is one specified by the UK Treasury. So far, the Treasury has specified only Libor,[7] but it may specify more benchmarks in the future. It is thus theoretically possible that a number of private, regulated or unregulated benchmarks can be brought within the scope of the offence. However, it is unlikely that market and transaction based benchmarks calculated from actual trading data, such as the FTSE 100, would be specified, since FSMA 2000's prohibition on market abuse already forbids transactions, orders to trade, or other behaviour that create misleading impressions or artificially increase the price of a security, as well as spreading misleading information about a security.[8] However, market abuse is currently not a criminal offence, so the UK's Financial Conduct Authority (the "FCA") will continue to only be able to levy fines and publicly censure individuals found to have committed it (although the scale of such fines should not be underestimated, for example the £17 million fine levied on Shell in 2004).[9]

The jurisdictional scope of the new offence is identical to section 397 of FSMA 2000: for misleading statements, it requires that they be either made in the UK, or to a person in the UK; misleading impressions must be created in the UK; and the course of conduct must take place in the UK.

KEY FINANCIAL REGULATORY CHANGES

The Wheatley Review also recommended changes to the financial regulatory rulebook, which governs the activities of financial services firms. In response, on 25 March 2013, the FSA published a Policy Statement[10] setting out the final version of its new rules on the

7 Section 93(4) Financial Services Act 2012 and The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2013.

8 Section 118, Financial Services and Markets Act 2000.

9 Section 123, Financial Services and Markets Act 2000.

10 FSA Policy Statement PS13/06: The regulation and supervision of benchmarks, March 2013.

regulation and supervision of benchmarks.[11] This follows publication of a draft text in December 2012.[12]

Two new regulated activities have been added to the rulebook from 2 April 2013: (i) providing information in relation to a specified benchmark; and (ii) administering a specified benchmark.[13] Any entity engaging in these activities will require the authorisation of, and be subject to, the oversight of the FCA.

The new rules fulfil one of the Wheatley Review's key recommendations: removing regulation of Libor submissions from the BBA and transferring future regulation to an administrator that is regulated and overseen by the FCA. The FSA acknowledged that the administration of Libor may be carried out by more than one entity and created the new regulated activity of administering a specified benchmark in order to ensure that all entities that succeed the BBA are subject to the FCA's oversight.

After the changes, the administrator(s) of Libor will be required to maintain effective systems to carry out the regulated activity. In carrying out tasks such as monitoring and validating submissions to benchmarks, the administrator(s) are required to create oversight committees. The oversight committee would be composed of benchmark users, market infrastructure providers, benchmark submitters and at least two independent members.[14] The oversight committee will be responsible for "*considering matters of definition and scope*" of the benchmark, scrutinising benchmark submissions, and notifying the FCA of those submitters who fail to meet the standards for submissions on a regular basis.[15]

Individuals who have managerial oversight and responsibility for staff who administer, collect, analyse and process benchmark submissions will require FCA approval as authorised persons carrying out a controlled function – the "*benchmark administration function*"[16] – as will individuals with responsibility for the submission process and who manage staff that make benchmark submissions – the "*benchmark submission function*".[17]

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11 The rulebook has been known as the FSA Handbook since its introduction by the Financial Services and Markets Act 2000. On 1 April 2013 the FSA was replaced by the Financial Conduct Authority and the Prudential Regulation Authority ("PRA"), and the FSA Handbook split between two new handbooks: the FCA Handbook and the PRA Handbook. The provisions discussed in this Update will be part of the FCA Handbook.

12 CP12/36, Financial Services Authority, December 2012.

13 The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2013.

14 MAR 8.3.8, FCA Handbook.

15 MAR 8.3.9, FCA Handbook.

16 CF50, SUP 10A.4.5 R, FCA Handbook.

17 CF40, SUP 10A.4.5 R, FCA Handbook.

Such authorised individuals are responsible for the governance of their respective benchmark administrators or benchmark submitters, as well as putting in place effective controls to manage possible conflicts of interests, especially in connection with sensitive data.

Submitting activity may happen outside the UK, through a Libor panel firm that does not have a UK establishment. The regulated activity is extraterritorial in scope as the FCA requires an individual to discharge the new controlled benchmark submission function "*regardless of where the submitting activity takes place*".[18]

MISLEADING STATEMENTS AND MISLEADING IMPRESSIONS

In addition to the creation of the new benchmark offence, FSA 2012 also makes amendments to two offences found in section 397 of FSMA 2000: making misleading statements and making misleading impressions. Section 397 of FSMA 2000 has been repealed and replaced by the two offences.

The restated offence of making misleading statements is almost identical to the previous version. Both prohibit (a) the making of misleading or false statements recklessly or with knowledge or (b) the dishonest concealment of any material facts (whether in connection with any statement made or otherwise) if a person intends to induce, or is reckless as to whether he or she may induce, another person to enter into, offer to enter into, or refrain from entering into or offering to enter into a relevant agreement. A relevant agreement is specified by Treasury Order and includes any agreement that is related to any regulated activity,[19] such as investment agreements, or controlled activities, or relating to a regulated investment.

The restated offence of making misleading impressions is also similar to the previous incarnation. The offence is committed when a person engages in any course of conduct which (a) intentionally or recklessly creates a misleading impression as to the market in, or the price or value of, any relevant investment, and (b) induces another to deal or not to deal (including acquisitions, disposals, subscriptions, and underwriting) in that investment, with the intent of making a gain for himself or another, or causing loss to another, or if that person is aware that the creation of a misleading impression is likely to produce gains for himself or another or loss to another.

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[18] 3.18, FSA Policy Statement PS13/06: The regulation and supervision of benchmarks, March 2013.

[19] Section 2, The Financial Services Act 2012 (Misleading Statements and Impressions) Order 2013.

The one key change to the offence of misleading impressions is the inclusion of the concept of gain or loss to another. Previously, the offence was only made out if the defendant intended to cause a gain for himself. Under the restated offence, for example, a bank's employee can be liable for making a misleading impression with the intent of increasing the bank's profit, whether or not the employee intended to benefit as well.

As far as jurisdiction is concerned, both sections 89 and 90 replicate the legacy position in section 397 of FSMA 2000. Section 89 requires the misleading statement or concealment of facts to be made in the UK or from the UK, or to induce a person in the UK. Alternatively, if the relevant agreement is or would be entered into in the UK or the rights exercisable in the UK, jurisdiction would also be made out. Section 90 requires the course of conduct to take place in the UK, or for the misleading impression to be created or engaged in the UK.

SUMMARY

The dual investigations led independently by the FSA and the SFO highlight the importance of Libor and other UK benchmarks and the importance that UK prosecutorial and regulatory bodies attach to ensuring that there should be no repetition of the Libor Scandal or similar undermining of UK benchmarks.

The new criminal offences build upon existing legislation, and broaden the scope of conduct required to commit a financial crime. Coupled with the regulatory changes, it appears that the UK legislative and regulatory response to the Libor Scandal has been robust, though it remains to be seen how effective the response will be in minimising financial crimes of this type in the future.

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Please do not hesitate to contact us with any questions.

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