Gem Briefing Note 17/2

September 2017

CP17/25: Individual accountability - extending the Senior Managers and Certification Regime to all FCA firms

Introduction

After the financial crisis, Parliament recommended the development of a new accountability system that was more focused on senior managers and individual responsibility. In response, the FCA (and PRA) created a new Senior Managers and Certification Regime (the 'SM&CR'), which came into force in March 2016 for banks, building societies, credit unions and large investment firms. The SM&CR replaced the existing Approved Persons Regime for these firms but the existing approved persons regime continues to apply to all other authorised and regulated firms.

Parliament subsequently amended FSMA to extend the new regime to all FSMA-authorised firms and CP17/25 begins to outline how the FCA proposes to do this.

The new regime aims to:

- encourage staff to take personal responsibility for their actions;
- improve conduct at all levels; and
- make sure firms and staff clearly understand and can demonstrate who does what.

The CP contains guidance on the format of draft Handbook text, which at this stage includes replacement of SUP 10A with SUP 10C and revoking of APER. The FCA, as part of its Reader's Guide, suggests solo-regulated firms read the text as follows:

- ignore the deleted text; and
- read the rest of the text, including un-amended text, as if it were new.

The FCA stresses that this consultation will be relevant to almost all financial services firms but not existing approved persons for, and other individuals within, Appointed Representatives (ARs) – the proposed approach for ARs will be covered in a separate CP. In advance of the next CP the FCA has highlight that principal firms, including the Senior Managers of principal firms, remain fully responsible for ensuring that their ARs and networks comply with its rules.

The FCA will also consult separately on operational aspects of the new regime, such as transitional arrangements (including of existing approved persons) and changes to forms. These proposals will form the 'technical CP'.

High-level Overview

The FCA proposes the application of a baseline of requirements to every firm, known as the 'core regime'. This means that the three main elements of the SM&CR will apply to every firm: the Senior Managers Regime, Certification Regime and Conduct Rules.

Key components of the regime are:

- **Senior Managers Regime** – which includes: designated senior manager functions (SMFs) and allocation of prescribed responsibilities, statements of responsibility, duty of responsibility, adherence to Senior Manager Conduct Rules.
- **Certification Regime** – for individuals whose role could cause significant harm to the firm or its customers – known as Certification Functions. These individuals do not need to be FCA approved but firms will need to check and confirm suitability of these people at least annually and these individuals will need to comply with the Individual Conduct Rules.
- **Individual Conduct Rules** – are basic standards of behaviour that people performing financial services activities in firms are expected to meet. Firms need to train their staff on the conduct rules and how the rules apply to their staff. Firms will also need to report breaches of Conduct Rules resulting in disciplinary action to the FCA every year.
- **Other staff (who are not ancillary staff)** will also need to comply with the Individual Conduct Rules.
- **Fit and Proper Requirements** – to be checked at appointment and at least once a year.
- **Regulatory References** – prescribed information firms need to share with each other when an SMF, NED (Non-executive Director) or Certification Function Holder moves from one firm to another.

In relation to NEDS, the new regime will only require FCA approval of the Chair rather than all NEDs. Therefore, some NEDs will not need to retain their approved persons status under the new Regime. However, the Senior Manager Conduct Rules, the fit and proper requirements and regulatory references will apply to all NEDs, even if they are not Senior Managers.

If an individual needs to hold more than one SMF, the firm can apply for both at the same time, using the same form and with one Statement of Responsibilities. However, the Statement must clearly describe all responsibilities pertaining to each function.

To reflect the different sizes and complexities of firms the FCA proposes:

- A Core Regime to apply to all firms other than Limited Scope firms;
- An Enhanced Regime of extra requirements for firms whose size, complexity and impact warrant more attention and who meet certain criteria – e.g. AUM of £50bn or more or intermediary regulated business revenue of £35m or more per annum; and
- A Limited Scope Regime of reduced requirements for the simplest/lowest impact firms – e.g. limited permission consumer credit firms, secondary insurance intermediaries, internally managed AIFs and Authorised Professional Firms (APFs).

The CP contains a firm-checker for firms to see which of the above regimes will apply and a table listing the 'tools' that apply depending on the firm's regime classification.

The following will only apply to the enhanced regime in addition to the requirements of the Core Regime:

- Handover procedures;
- Other overall responsibility function;
- Overall responsibility; and
- Responsibilities maps.

Senior Manager Functions (SMFs)

The functions under the core regime are as follows:

- **Governing functions**
  - ➡ SMF1 – Chief Executive
  - ➡ SMF3 – Executive Director
  - ➡ SMF27 – Partner
- **Governing function - Non-Executive**
  - ➡ SMF9 – Chair
- **Required Functions**
  - ➡ SMF16 – Compliance Oversight
  - ➡ SMF17 – MLRO

The functions that will apply to varying degrees to limited scope firms include:

- SMF29 – Limited scope Function – currently called the Apportionment and Oversight Function (CF8)
- SMF16 – Compliance Officer
- SMF17 – MLRO

FSMA granted the FCA new powers to apply conditions and time limits when approving Senior Managers. SUP 10C contains a Statement of Policy regarding the FCA's new powers. An example of where time-limited approval may apply might be where a firm needs to appoint a candidate on an interim basis while seeking a permanent candidate for a particular function.

Prescribed Responsibilities

The FCA is proposing six responsibilities ('Prescribed Responsibilities') for core firms that must be given to Senior Managers, and an additional responsibility for Authorised Fund Managers (AFMs), which was described in CP17/18: *Consultation on implementing asset management market study remedies and changes to Handbook*.

1. Performance by the firm of its obligations under the Senior Managers Regime, including implementation and oversight
2. Performance by the firm of its obligations under the Certification Regime
3. Performance by the firm of its obligations in respect of notifications and training of the Conduct Rules
4. Responsibility for the firm's policies and procedures for countering the risk that the firm might be used to further financial crime
5. Responsibility for the firm's compliance with CASS (if applicable)
6. Responsibility for ensuring the governing body is informed of its legal and regulatory obligations
7. Responsibility for an AFM's value for money assessments, independent director representation and acting in investors' best interests

Each Prescribed Responsibility should be given to the Senior Manager who is the most senior person responsible for that issue and who has the appropriate level of knowledge and competence to carry out the responsibility.

Each Prescribed Responsibility should normally be held by only one person and firms will only be able to divide (where SMFs have responsibility for different parts of a Prescribed Responsibility) or share a Prescribed Responsibility in limited circumstances where it can be properly justified – e.g. during a handover. Where responsibilities are shared each SMF will be jointly accountable.

As part of its justification for dividing/sharing a Prescribed Responsibility the firm must:

- Show that the division/sharing does not leave a gap; and
- Clearly explain the division/sharing in the Responsibility Statements for each SMF.

In respect of partnerships, where a partner has no involvement in managing the firm the individual is unlikely to meet the overarching FSMA definition of Senior Manager and therefore the partner SMF may not apply.

Statements of Responsibility

These are to be submitted along with an application for approval, kept up-to-date and resubmitted if there are significant changes to the Statement (see guidance in SUP 10C).

The FCA will consult separately on the proposed template and process for submitting the statements to the FCA.

The FCA will consider an individual's Statement of Responsibilities when deciding whether or not to take enforcement action against them.

Duty of Responsibility

If a firm breaches one or more requirements, the Senior Manager(s) responsible for the area(s) in question could be held accountable if the Senior Manager(s) did not take 'reasonable steps' to prevent or stop the breach.

Although the burden of proof lies with the FCA to show that the Senior Manager(s) did not take the steps a person in their position could reasonably be expected to take to avoid the firm's breach occurring, it is certainly advisable for Senior Managers to clearly document their actions, decisions and rationale for both.

Certification Regime

For those individuals that aren't SMFs but whose jobs mean they can have a significant impact on customers, the firm and/or market integrity, the Certification Regime will apply. For the avoidance of doubt, the Certification Regime will only apply to employees, not to NEDs.

Functions that meet the FSMA definition of a Certification Function are:

- Significant Management Function (based on the current CF29)
- Proprietary traders
- CASS oversight (currently CF10a)
- Functions subject to qualification requirements, e.g. mortgage advisers, retail investment advisers – a full list is available in the TC Sourcebook
- Client dealing function –
    - ➡ an expansion of the current CF30 function and will include dealings with professional clients and eligible counterparties as well as retail clients
    - ➡ includes advising, dealing, arranging, investment activity, acting as investment manager and all connected functions, bringing about deals in investments and dealing in investments as agent or principal
- Anyone who supervises/manages a Certified Function, directly or indirectly
- Material Risk Takers (aka Remuneration Code staff)
- Algorithmic trading

Certification Function holders will not appear on the FS Register, however feedback on this point has been requested, as it has caused some controversy.

The functions will also only apply where the firm has people in these roles, therefore some very small firms may not have any Certification Function holders.

Firms need to issue certificates to those under the Certification Regime who have been assessed as fit and proper stating this fact and setting out what aspects of the firm's affairs the person will be involved in as part of performing their function.

The certificate is only to be valid for a year. The firm will have to renew it if the employee is to carry on performing the function. If the firm decides not to issue a certificate the firm must give the person a notice setting out what action the firm proposes to take and the reasons for proposing this action.

Fit and Proper (F&P) Requirements

The F&P Requirements will apply to both Senior Managers and Certification Staff, and to NEDs, at appointment and on an ongoing basis at least once a year.

Firms should have regard to existing rules and guidance concerning appropriate qualifications, training, competence and personal characteristics required for role but no new rules are proposed at this stage.

The Fit and Proper Test (FIT) criteria is to be extended to cover Senior Managers and Certification Staff and new evidence for firms to collect includes the following, although some firms may already collect this:

- Criminal records checks including spent convictions, as part of application process – mandatory for Senior Managers but not certified staff,
- Regulatory references from past employer's in the last 6 years.

Regulatory References

Regulatory references are to be requested and provided by authorised firms in respect of SMFs, NEDs or Certification Function Holders, and the references must follow a standard template - see SYSC 22 Annex 1R in draft Handbook rules for proposed template.

Firms must disclose information going back 6 years, although there is no time limit for serious misconduct, and provide updated references to previous versions where new, significant information comes to light.

Firms must retain F&P and disciplinary records for 6 years and not enter into arrangements that conflict with disclosure obligations (e.g. non-disclosure agreements).

A Senior Manager is to be allocated responsibility for the firm's regulatory reference obligations.

Firms will still need to comply with common law duties and other relevant legislation.

Conduct Rules

The Conduct Rules are to replace the the Statements of Principle and Code of Practice for Approved Persons (APER) and enable the FCA to hold people, not just those approved by the FCA, to account.

The Rules comprise basic standards of good personal conduct over two tiers:

- the first tier is for individuals (most employees within a firm including Certified Staff), and
- the second tier is for Senior Managers.

NEDs who are not Senior Managers will be subject to the Individual Conduct Rules and also the 4th rule (SC4) of the Senior Manager Conduct Rules.

The Rules apply to a firm's regulated and unregulated financial services activities and any related ancillary activities, which is a narrower approach than for the SM&CR for banking.

The Rules are not applicable to ancillary staff – e.g. receptionists, post-room staff, IT support staff (i.e. helpdesk) - see the CP for more roles that will be out of scope.

Training and Notification Requirements

Firms need to make all staff who are subject to the Conduct Rules aware of that fact and train them on how the rules apply to them.

When a firm takes disciplinary action against a person for breach of the Conduct Rules it is required to notify the FCA: annually for Certification Staff and within 7 business days of the firm becoming aware of a Senior Manager breach. A later consultation will contain a proposed form and process for these notifications. However, the FCA states these notifications won't replace firms' obligations to report concerns about an individual's conduct under existing rules and principles.

Additional Requirements for Enhanced Firms

The FCA proposes additional requirements for firms within the scope of the Enhanced Regime, as mentioned above.

Other points to note are as follows:

- The Enhanced Regime includes additional SMFs and Prescribed Responsibilities,
- Limited scope firms and EEA and non-EEA branches will not be subject to the enhanced regime even if they meet the criteria,
- When a firm meets the criteria the regime will apply automatically, subject to a transition period of 6-months, so monitoring of the criteria is required,
- The FCA could apply the Enhanced Regime as an Own Initiative Requirement even where the criteria are not met by the firm,
- Firms that meet the criteria could apply for a waiver if they don't feel the Enhanced Regime should apply to them,

- If a firm in the Enhanced Regime stops meeting the criteria the regime will continue to apply for one year, and

- There will be a transitional period and arrangements for Senior Managers when moving between the core and enhanced regimes.

Cost

The FCA's estimated total one-off and ongoing costs of the proposals to firms is on average £550m and £175m, respectively. The FCA believes it will incur costs of around £13.4m over 4 years as the new regime is developed and implemented. However, the FCA does not indicate how and when it will recoup its costs from authorised firms.

Next Steps

The consultation period for this CP closes on 03/11/17 and final rules are to be published next year along with a date for them to commence. However, the FCA states that some proposals may not be implemented once the FCA has considered and consulted on its approach to other aspects of the extended regime, such as its proposed approach to ARs. The FCA will also assess, and update where necessary, its proposals in the event of changes to the UK's regulatory framework, including as a result of Brexit.

The full CP can be accessed here.

This note is intended as a summary only. It is not full and/or firm specific advice and it is the responsibility of each regulated firm to ensure they fully consider relevant FCA publications.

For further information, please contact Gem Compliance Consulting Ltd.