

Senior Managers and Certification Regime

Impact on Asset Managers

April 2019



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SECTION 1

WHAT IS THE SENIOR MANAGERS AND CERTIFICATION REGIME?

On 9 December 2019, the Senior Managers and Certification Regime (the “**SMCR**”) will be extended to cover all UK firms that are regulated solely by the UK Financial Conduct Authority (“**FCA**”). This category of firms includes UK authorised fund managers (e.g. AIFMs and UCITS Management Companies), UK sub-managers providing portfolio management services to a US or overseas investment manager, and UK firms providing single managed account services. One of the few categories of firm that will remain outside of this broad scope are firms that are active in the asset management sector but that simply function as Appointed Representatives for other, licensed, entities.

This extension in the scope of the SMCR to asset managers and other “solo-regulated firms” will represent a major step towards increasing individual accountability amongst senior managers and ensuring that staff throughout regulated firms are required to operate in accordance with FCA conduct requirements.

We have summarised in this briefing a number of practical steps that UK asset management firms can take over the coming months to ensure their readiness for the December implementation deadline, with a particular emphasis on the strategies that senior managers will need to adopt in order to ensure that they comply with the spirit as well as the letter of the regulatory framework. Alongside these more practical steps, however, there are a number of fundamental questions that the asset management sector will need to engage with more generally in the lead-up to implementation.

Fundamental questions for the UK asset management sector

- The SMCR has its roots in a policy that was designed to enable regulators to map out responsibilities within large, internally complex banking institutions. How can asset managers ensure that they apply this framework in a manner that is proportionate and better suited to smaller, less complex organisations where a much smaller group of individuals are undertaking senior, potentially overlapping, roles within the organisation?
- In an environment where senior managers are exposed to an increased risk of personal regulatory enforcement action, how can senior individuals in asset management firms foresee what the major potential pitfalls are likely to be, given that the sector has historically had a more limited level of enforcement action in the senior management space?
- How can compliance officers and other senior managers use the SMCR as a springboard to engage with broader issues around ongoing compliance culture (which, according to the FCA itself, is at the root of the reforms)?
- In a sector that many now feel is saturated with regulation, how can senior managers overcome “regulatory fatigue” amongst their Certified and Conduct Staff and engage them in the process of implementing the SMCR framework?

OVERVIEW: WHAT WILL CHANGE FOR UK ASSET MANAGERS?

The SMCR introduces four major reforms for asset managers, which this briefing deals with in turn:

- the Senior Managers regime (see [Section 3](#));
- the Certified Persons regime (see [Section 4](#));

- the SMCR Conduct Rules (see [Section 5](#)); and
- the Regulatory Reference regime (see [Section 7](#)).

The application of these rules will vary depending on the firm's classification (see [Section 2: Classifying Your Firm](#)), and they are also subject to slightly different phase-in periods (see [Section 8: Timeline](#)). Firms will also need to review the manner in which they approach monitoring fitness and propriety on an ongoing basis (see [Section 6: Assessing Fitness and Propriety](#)).

HOW SHOULD SENIOR MANAGERS IN THE ASSET MANAGEMENT SECTOR APPROACH IMPLEMENTATION?

Ensuring compliance with the SMCR will not simply be a case of updating a firm's internal policies and rolling out a training programme (although both of these steps are absolutely necessary for compliance with the regime); the regime is intended to represent a major shift in responsibility from the regulator to individuals involved in running regulated firms. It is critical that senior managers understand the extent of regulatory liability to which they are subject, and that they analyse what steps they can take to help protect themselves both at the point of implementation and on an ongoing basis. Ultimately, this analysis will vary depending on the asset manager, its trading strategy, its size and governance structure. However, in order to assist with this process, we have set out in this briefing to educate senior managers not only on the structure of the regime, but also on the practical steps they can take and questions they can ask themselves to ensure that they are effectively engaging with the new theme of individual responsibility.

HOW CAN BAKER MCKENZIE HELP?

We have identified at each stage of this briefing training requirements, internal documentation and revised contractual drafting that will be required for implementation of the SMCR, all of which we can assist with delivering to regulated firms. Our market-leading employment team and cross-discipline advisory and contentious regulatory team are also able to provide a range of more bespoke solutions and ongoing implementation support.

SECTION 2

CLASSIFYING YOUR FIRM

Timing: Perform assessment ASAP

The first step to implementing the SMCR framework will be to assess whether your firm should be classed as Core, Limited or Enhanced. In summary, the three SMCR categorisations comprise the following firms:

- **Limited Scope Firms** – covers internally managed AIFs, consumer credit firms, sole traders and energy market participants that are currently subject to a more limited version of the Approved Persons regime;
- **Core Firms** – covers those FCA-regulated firms that do not meet the thresholds for classification as either an Enhanced or as a Limited Scope firm; and
- **Enhanced Firms** – covers firms meeting a sector-based test of size and complexity, which will notably bring CASS large firms, significant IFPRU firms, and firms with assets under management of over £50 billion.

Firms should consider their classification (and whether it is likely to change in the near future as a result of, say, a predicted increase in assets under management) given that the FCA will be contacting each firm in the lead-up to implementation to inform them of the category it has assigned to them. Firms should check their assigned categorisation and confirm that it accords with their internal analysis.

How should asset managers be classified?

- Outside of the internally managed AIF category, firms active in the asset management sector would not ordinarily fall within the Limited Scope category (this is true even for sub-managers with more limited regulatory permissions covering solely advising and arranging activities) As such, we have not focused on the Limited Scope classification in this briefing.
- The question therefore becomes: when will an asset management firm be classified as an Enhanced firm rather than as a Core firm?
 - The differentiator for these purposes will generally lie in whether the firm has assets under management (“AUM”) of £50 billion or more, calculated as a three year rolling average.
 - A firm’s AUM for these purposes will be the same figure that would be reported in its FSA038 submission (thus, if an asset management firm submits its FSA038 on a bi-annual or six-monthly basis, it would calculate its average AUM after each submission, using the most recent return and the five preceding returns)¹.
 - Importantly for UK sub-managers, only the portion of the fund for which the sub-manager has been delegated responsibility should be included in this calculation.
- Given the level at which this threshold has been set, we would expect the majority of UK asset management firms to be classed as Core firms.

¹ See page 53 of the FCA’s Policy Statement 18/14 on extending the Senior Managers & Certification Regime to FCA firms.

SECTION 3

SENIOR MANAGERS REGIME

Timing: Map out responsibilities and engage with Senior Managers ASAP

We have set out below a number of steps that firms will need to take in ensuring that their senior managers have been identified and appropriately allocated with “Prescribed Responsibilities”. However, senior managers should bear in mind that although the steps laid out in this section will go some way to satisfying their regulatory responsibilities, the most significant change in the way that they approach and consider their day-to-day responsibilities will likely arise from the new conduct framework that we have set out in [Section 5](#) of this briefing.

STEP 1: IDENTIFY SENIOR MANAGEMENT FUNCTION HOLDERS

What are Senior Management Functions?

In the lead-up to SMCR implementation, firms must identify those individuals within their organisations that carry out Senior Manager Functions. For Core firms, Senior Management Functions comprise the following:

- Chief Executive
- Executive Director
- Chair
- Compliance Oversight
- Money Laundering Reporting Officer (“MLRO”)
- Partner

Of these, only the MLRO and the Compliance Oversight functions are required to be allocated to senior managers within the firm; the other functions need only be allocated to the extent that they are relevant to the business (e.g. depending on whether it is structured as a corporate or partnership). Notably, there is no Senior Management Function for General Counsel, following significant debate on the point.

Several additional categories of Senior Management Functions will apply to Enhanced firms, including, for example, Chair of the Remuneration Committee, Chief Finance Officer, and “Other Overall Responsibility” (intended to capture senior individuals responsible for an area of the firm’s business not otherwise covered by the Senior Managers regime).

What does categorisation as a Senior Management Function holder entail?

There are three central obligations that attach to Senior Management Function holder (“SMF”) status, as follows:

- each SMF’s duties and responsibilities must be summarised in a “Statement of Responsibilities”, against which their activities can be reviewed and benchmarked;
- each SMF will owe a “Duty of Responsibility” to the FCA, such that if the SMF fails to take reasonable steps to prevent his or her firm from breaching an FCA requirement in an area under that SMF’s oversight, the SMF can be held personally accountable for the breach; and
- SMFs will be allocated responsibility for a number of “Prescribed Responsibilities”, as detailed in “Step 2: Allocate Prescribed Responsibilities” below.

Conversion to SMF status

The FCA will automatically convert Approved Persons in Core firms to SMFs where there is a senior management function that corresponds to their current status (note that this conversion would not occur

automatically for Enhanced firms, but would instead be dealt with *via* a conversion notification or “Form K”). In other words, Core firms should not need to file applications or reapplications on behalf of their existing Approved Persons, assuming that their role remains the same post-SMCR. For any new SMFs appointed post-SMCR implementation, or for individuals that are performing Senior Management Functions without appearing in the FCA Register for some reason, a Form A would need to be filed.

Practical issues: identification of senior managers

(A) Scoping issues

- Asset managers should bear in mind that the aim here is to map out their existing business and governance structure rather than, say, hiring new individuals to perform additional senior management roles.
- It will be possible within smaller organisations for the same individual to perform more than one senior management function, although a separate approval will be necessary for each function.

(B) Extraterritoriality

- Importantly, there are no territorial limitations on the scope of the senior manager categorisation; senior managers may be based outside of the UK provided that they perform one of the functions listed above.
- One of the reasons that it will be imperative for firms to assess their governance structures in the lead-up to SMCR implementation is to ascertain whether any individuals based outside of the UK could be caught by the scope of the Senior Managers’ Regime as a result of having a substantial say in the management of the organisation. For example, even if a non-UK individual has not formally been appointed as a Director, it is conceivable that the regulator could come to the view that they are acting as a “de facto” Director who should be caught by the scope of the framework.
- Aside from this issue, having a designated senior manager who is ordinarily resident in the US should not, for example, pose an issue under the SMCR. However, the firm in question will need to consider more carefully how it goes about giving that individual the necessary tools to demonstrate competency to the FCA on an ongoing basis. Alongside the training on the SMCR framework that SMFs are required to undertake, ongoing training on the UK regulatory framework may assist the overseas SMF in showing that he or she has taken reasonable steps to ensure that any business they manage is operating in compliance with the UK regulatory framework (see [Section 5](#)).
- The emphasis in the SMCR on effectively overseeing any delegates may also mean that more regular trips to the UK or a greater emphasis on staying current with arrangements in the UK office *via* video link conferencing etc. are required.

(C) Partners in UK LLPs

- For those asset managers that are structured as LLPs, careful thought will need to be given to the issue of which partners can truly be said to be “senior managers” for the purpose of the SMCR.
- The FCA has stated that, in its view, “most partners will have some involvement in managing a firm”, but that it is ultimately for the firm itself to make this determination, based on guidance in the FCA

Handbook.

- Thus, in the run-up to SMCR implementation, the FCA is encouraging firms to consider whether partners that are currently approved as CF4s (i.e. the current Partner Function) meet the SMF definition. If they do not, Core firms will need to submit a Form C to cancel that Partner's approval².
- Firms should bear in mind, however, that treating a partner as not having a significant influence over the business could have tax consequences under HMRC rules. Tax advice may need to be taken on this point if it is likely to become an issue.

STEP 2: ALLOCATE PRESCRIBED RESPONSIBILITIES

The SMCR requires a number of "Prescribed Responsibilities" to be allocated across SMFs. For Core firms, these Prescribed Responsibilities include responsibility for the following:

- a) the performance by the firm of its obligations under the Senior Managers Regime, including implementation and oversight;
- b) the performance by the firm of its obligations under the Certification Regime (note that this responsibility must be allocated even where the firm is so small that it has no certified staff);
- c) the performance by the firm of its obligations in respect of notifications under and training on the Conduct rules (see [Section 5](#));
- d) policies and procedures for countering the risk that the firm might be used to further financial crime;
- e) compliance with CASS (if applicable); and
- f) in relation to Authorised Fund Managers, value for money assessments, independent director representation and acting in investors' best interests (note that this Prescribed Responsibility must be assigned to the firm's Chair where it has one).

Point (f) above arose from the FCA's Asset Management Market Study ("**AMMS**"),³ and will apply solely to Authorised Fund Managers (e.g. UCITS Mancos). Although the FCA has provided certain broad guidance in PS18/14⁴ in connection with the AMMS (e.g. that "value for money assessments should not focus purely on costs", and "fund charges should take into account the context around the whole service provided"), there will be a fair amount of work to do for the SMF in question in understanding the firm's obligations under the AMMS and ensuring that they are met on a continuing basis.

Note that Enhanced firms will also need to implement several additional Prescribed Responsibilities (e.g. responsibility for ensuring compliance with rules relating to the firm's responsibilities map).

Practical issues: allocation of Prescribed Responsibilities

- Firms will need to ensure that the correct individual within their organisation is allocated each Prescribed Responsibility, and that they are given the appropriate resources and training to perform their role effectively.
- It may make most sense for firms to concentrate initially on where responsibility for compliance with the senior manager regime, certification regime and conduct rules training will sit, given that these

² Enhanced firms can simply leave this individual out of their submitted Form K and the individual's function will not be converted.

³ See our related client alert: "FCA Imposes Remedies after Asset Management Market Study - How Should You Respond?"

⁴ The FCA's Policy Statement setting out near-final rules on SMCR implementation.

are new responsibilities, and these individuals will be spearheading compliance with the SMCR regime. Allocation of the three remaining prescribed responsibilities will hopefully be more straightforward, based on an analysis of who has primary responsibility for these areas at present.

- Any change or redistribution to Prescribed Responsibilities following implementation of the SMCR will not require a Senior Manager to be re-approved, but will require an adjustment in their Statement of Responsibility.
- Although it is possible for one Prescribed Responsibility to be split between two individuals, the circumstances in which this will be appropriate are limited to situations where the firm can show that it is appropriate and justifiable (e.g. where two senior managers work together for a short period as part of a handover, or as part of a job share arrangement). Given the restrictive nature of these conditions, it will be most straightforward to simply allocate each Prescribed Responsibility to a single individual wherever possible.

STEP 3: DRAFT STATEMENTS OF RESPONSIBILITIES

Each SMF will need to have a “Statement of Responsibilities” under the new regime. This document is intended to clearly set out the SMF’s role and which aspects of the firm’s business he or she is responsible for. These statements must be kept up to date and revised if any material change to their content is required (e.g. in the situation where a SMF has a Prescribed Responsibility added or removed from their responsibilities).

Practical issues: drafting and reviewing Statements of Responsibilities

- Firms should engage with SMFs and ensure that each SMF agrees to the content of their particular Statement of Responsibilities, given that SMFs will be held individually accountable in relation to the responsibilities listed.
- When drafting Statements of Responsibilities, firms should consider not only what the nature of the SMF’s role is in the organisation; they should also consider the general framework of regulatory and compliance obligations that the firm is subject to, and ensure that the Statements of Responsibilities reflect these major compliance obligations without leaving gaps.
- A firm’s Statements of Responsibilities should also be read together across SMFs to ensure that pitfalls like circular reporting lines, or overlaps in responsibilities, are avoided (the FCA has been clear, for example, that if two Senior Managers are accountable for a similar area of responsibility, the firm in question must clearly describe the dividing line between the two areas).
- Note that Statements of Responsibilities are intended to be concise, self-contained documents; they cannot incorporate material by reference. The FCA has set out some helpful guidance on their content in its Guidance Paper FG 19/2.⁵

STEP 4 (FOR ENHANCED FIRMS ONLY): DRAFT RESPONSIBILITIES MAP

Where a firm falls into the Enhanced category, it will need to draft a Responsibilities Map, i.e. a document that is intended to provide an overview of how a firm is managed and governed. These Responsibilities Maps are intended to be practical documents that are clear and easily understandable for both regulators and individuals who work for the firm.

⁵ See FG19/2 Senior Managers and Certification Regime: Guidance on statements of responsibilities and Responsibilities Maps for FCA firms.

Responsibilities Maps will contain key information around governance bodies, senior management reporting lines and Senior Managers' responsibilities, and would usually be a mixture of graphics and text. Where the firm is part of a group, the map should clearly show how the firm relates to its wider group (see the "Practical Issues" box below – this may in particular be an issue for UK sub-managers of US investment managers).

Practical issues: drafting Responsibilities Maps

- Firms should draft Responsibilities Maps with a view to making clear what the governance structure of the firm is and who within the firm is responsible for strategic decisions (e.g. situations in which decisions would be made through committees rather than by individuals acting alone). As in the case of Statements of Responsibilities, the map should highlight the distinction between reporting lines that might otherwise appear to be duplicative in some way.
- In situations where the UK firm operates as a subsidiary to or affiliate of a US investment manager, the Responsibilities Map will need to make clear the role of any group-level governance committees (e.g. global risk committees), and identify any key group-level individuals with influence over the UK entity.

Required Documentation

SMF Handbook

SMF training materials

Revised drafting for SMF employment contracts / partnership agreements. This revised drafting will need to cover a number of new issues, e.g.:

- a duty for the SMF to comply with the terms of his or her Statement of Responsibilities and Prescribed Responsibilities;
- a duty for the SMF to comply with the SMCR Conduct Rules and to notify the firm of any Conduct Rule breaches;
- amendments to termination provisions, taking into account Conduct Rule breaches and the potential for revised regulatory references to be sent during the SMF's period of employment.

The wording of Settlement Agreements will also need to be considered.

The process of putting together Statements of Responsibilities may trigger firms to revisit and revise their governance procedures more generally (e.g., if reporting lines are unclear or need to be changed in some way).

SMFs may also wish to revisit the firm's Director and Officer Liability Insurance Policy in light of the SMCR.

SECTION 4

IDENTIFYING CERTIFIED EMPLOYEES

Timing: Certified Employees will need to be identified by 9 December 2019, but firms will have until December 2020 to complete the initial certification process

WHO WILL BE WITHIN SCOPE OF THE CERTIFICATION REGIME?

The certification regime will apply to any non-SMF individuals who are currently classified as Approved Persons (e.g. those performing a CF30 function); however, it could extend beyond this universe to others who may not previously have been Approved Persons (e.g. to individuals who are not directly performing a client dealing function, but who manage those that do). We have set out below a table of roles requiring certification under the SMCR regime.

Employees who are not Senior Managers but whose activities could result in “serious harm” to the firm, consumers or market integrity more generally will be subject to the Certification regime. Note that the FCA has confirmed that the term “employee” could cover secondees and contractors for these purposes, so firms will need to keep track of any individuals operating in this capacity. Secondment arrangements (e.g. between different offices) are, in particular, not uncommon amongst asset management firms.

WHAT DOES IT MEAN TO BE A CERTIFIED EMPLOYEE?

Inclusion within the Certification Regime will result in:

- a requirement for the individual’s fitness and propriety to be assessed at least annually (see [Section 6](#) of this briefing);
- compliance with the SMCR conduct rules (see [Section 5](#) of this briefing); and
- more stringent rules around referencing (see [Section 7](#) of this briefing).

Under the SMCR regime, however, Certified Employees will no longer be directly approved by the FCA, which reflects a general shift in responsibility for diligencing and monitoring individuals from the regulator to regulated firms.

Role Requiring Certification	Comments
Client dealing	Under the SMCR, the definition of a “client dealing function” will be expanded from the current CF30 category to cover any individual dealing with clients (whether retail or professional). However, for asset management firms, the scope is likely to be very similar to CF30, given that it will continue to cover individuals involved in advising, arranging, dealing as agent and portfolio management activities.
Algorithmic trading	The algorithmic trading function will include individuals with responsibility for: <ul style="list-style-type: none"> • approving the deployment of a trading algorithm, or a material part of an algorithm (note that this covers the deployment of an existing algorithm on a new trading venue where it has not previously been used); • approving the deployment of a material amendment to a trading algorithm, or a material part of one, or the combination of trading algorithms; and/or

	<ul style="list-style-type: none"> monitoring, or deciding, whether or not the use or deployment of a trading algorithm is, or remains, compliant with the firm's obligations (this would include validation and stress testing).
Material risk takers	The concept of material risk takers (aka "remuneration code staff") already exists for asset management firms subject to either the AIFMD, UCITS, IFPRU or BIPRU. The FCA is not amending this definition in connection with the SMCR, so identifying the relevant individuals should be straightforward. This may, however, be an opportune time to assess whether all relevant individuals have been correctly identified in line with the relevant rules.
Proprietary traders	This category of individuals, which covers CF29 staff, would not ordinarily be relevant to asset managers, given that they do not generally take proprietary positions.
Functions requiring qualifications	The qualification requirements in question are set out in the FCA Training and Competence Sourcebook; given that many are retail-focused (covering roles like mortgage and retail investment advisers), they are less likely to be relevant to asset managers.
CASS oversight	This category would cover individuals that are currently classed as CF10a, and who have oversight of the operational effectiveness of the firm's compliance with CASS.
Significant management	This category would cover individuals currently classed as CF29, e.g. senior managers with responsibility for a significant business unit that makes material decisions on the commitment of a firm's financial resources, its financial commitments, its asset acquisitions, its liability management and its overall cash and capital planning.
Managers or supervisors of Certified Employees	This category covers any other individual who supervises or manages Certified Employees (whether directly or indirectly). It is intended to ensure a clear chain of accountability between junior Certified Employees and the SMF who is ultimately responsible for that area.

Practical issues: identifying Certified Employees

(A) Scope issues

- In implementing the Certification Regime, firms should take the approach of ensuring that their cohort of Certified Employees meets the standard set by the FCA descriptions above, but does not go beyond it (in the sense of drawing a needlessly high number of individuals into the regime).
- Note that it is possible for the same individual to be both a Senior Manager and a Certified Person (e.g. in the situation where one single individual is a partner of an LLP, and also has authority to execute trades). In these cases, the individual would need to be approved by the FCA as a Senior Manager as well as being certified by his or her firm.
- Unlike Senior Management Functions, which apply regardless of location, the Certification regime does not apply on a fully extraterritorial basis. The FCA has expressed the view that employees must be certified if they perform a certification role and either: (i) they are based in the UK (or spend more than 30 days a year in the UK); or (ii) they deal in some way with UK clients. In the FCA's view, where an employee spends more than 30 days working from a UK office, they will pose an increased risk to the market, and they must therefore meet the same conduct standards as other

Certified Employees⁶.

- However, there is no such territorial limitation for individuals who are classed as “material risk takers” (i.e. Remuneration Code staff); for these individuals, the Certification Regime will apply regardless of where they reside.

(B) Client dealing

- For many asset managers, the client dealing function will cover the greatest proportion of Certified Employees (although note that for those managers that use algorithms to trade, there will likely be a crossover with the algorithmic trading function). Portfolio managers and traders will in particular fall within scope of this function, but careful thought should be given to whether others that are involved in investment decision-making in some way may also be caught.

(C) Algorithmic trading

- Since the introduction of MiFID II, algorithmic trading has been an increasing area of focus for regulators, and the introduction of the algorithmic trading certification function reflects this heightened level of scrutiny.
- Given that many hedge funds in particular use algorithms to execute trades or generate investment decisions, there will be a scoping exercise around which traders and portfolio managers could be caught by this function, bearing in mind that the FCA Handbook definition of a “trading algorithm” in this context ultimately refers back to the MiFID II definition of an algorithm (which extends in certain circumstances to “investment decision” algorithms that do not interact directly with the market)⁷.
- The FCA has been clear that the algorithmic trading certification function will apply whether the firm develops an algorithm itself or buys one from a third party. In addition, if a firm uses a third party algorithm, the FCA has specified that there must be someone in the firm that is accountable for: (i) the decision to use the algorithm; and (ii) how the algorithm behaves on an ongoing basis⁸.
- This may create issues in particular around the use of execution algorithms provided by brokers. Whilst an individual at an asset manager may be given responsibility for monitoring that the algorithm is behaving as intended, they would not actually have the ability to change its source code, and would potentially not have the capacity to alter its functioning (other than by exercising a kill switch). In these situations where the firm has more limited control over the operation of the algorithm, careful thought will need to be given to how fitness and propriety assessments should be run in relation to individuals with oversight of the algorithm.
- Another factor that may widen the scope of this certification category is that the algorithm may require sign-off from different people about different aspects of the decision or approval to utilise it, and the fact that it is intended to apply to certain operational aspects of algorithmic trading (e.g. validation and stress testing). Including testing requirements within the scope of the certification regime may draw in staff who are involved in more operational roles rather than those who would ordinarily oversee algorithmic trading activities day-to-day.
- Firms should also bear in mind that the SMCR framework applying to algorithms kicks in before algorithms are actually deployed; whilst it will not apply to algorithms that are currently under development, it would appear to apply to “dormant” algorithms that are capable of being used in the

⁶ See page 31 of FCA Policy Statement 18/14.

⁷ See FCA Glossary.

⁸ See page 30 of FCA Policy Statement 18/14.

generation or acceptance of orders but that are not actually generating or accepting them at the present time⁹.

Required Documentation

Certified Employees Handbook

Revised wording to be inserted into Certified Employee employment contracts, e.g.:

- positive fitness and propriety assessment to be built into the conditions of employment;
- a duty to comply with the SMCR Conduct Rules and to notify the firm of any Conduct Rule breaches; and
- amendments to termination provisions, taking into account Conduct Rule breaches and the potential for revised regulatory references to be sent during the Certified Employee's period of employment.

⁹ See SYSC 27.8.

SECTION 5

SMCR CONDUCT RULES

Timing: SMFs and Certified Employees to be trained on Conduct Rules by 9 December 2019, other Conduct Rule Staff to be trained by 9 December 2020

SCOPE

The SMCR introduces the concept of “Individual Conduct Rules”, which will apply to all staff within a firm, with the exception of individuals who perform solely “ancillary” roles (e.g. receptionists, post room staff, security guards and information technology support). Thus, the scope of the conduct rules will apply beyond SMFs and Certified Employees, to other individuals outside the pure Ancillary category (a.k.a. “Conduct Rule Staff”). These rules will need to be adhered to both in connection with the firm’s regulated activities, and any unregulated activities that staff also perform. We have set out the Conduct Rules in the table below (note that there is a further set of Senior Manager Conduct rules that will only apply to SMFs).

Each member of staff that is caught by the Conduct Rules will need to be trained on compliance and how the rules apply to their day-to-day activities. This will mean the creation of a bespoke education and training programme.

SMCR CONDUCT RULES	
Individual Conduct Rules (Apply to SMFs, Certified Employees and Conduct Staff)	Senior Manager Conduct Rules (Apply solely to SMFs)
Rule 1: You must act with integrity.	SC1: You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
Rule 2: You must act with due skill, care and diligence.	SC2: You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.
Rule 3: You must be open and cooperative with the FCA, the PRA and other regulators.	SC3: You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
Rule 4: You must pay due regard to the interests or customers and treat them fairly.	SC4: You must disclose appropriately any information of which the FCA would reasonably expect notice.
Rule 5: You must observe proper standards of market conduct.	

WHAT HAS ACTUALLY CHANGED?

Individual accountability

The content of the Conduct Rules, e.g. the requirement to act with integrity, as well as due care, skill and diligence, will be generally familiar from the current UK regime. However, the key difference is that under the SMCR, the Conduct Rules will be directly enforceable by the FCA. The FCA's stated aim is to "improve individual accountability and awareness of conduct issues", and "in turn achieve the culture change that we are seeking"¹⁰. It is clear from statements like this that the aim of individual accountability under the new conduct framework is not simply to facilitate enforcement actions, but also to create a new awareness of conduct regulation across individuals working in regulated firms and improve compliance culture more generally.

Breaches

Where an individual within the firm breaches the Conduct Rules and the firm takes disciplinary action against him or her as a result (which could simply take the form of a written warning), the FCA will need to be notified.

KEY ISSUE FOR SENIOR MANAGERS: THE REASONABLE STEPS STANDARD

Where does this standard come from?

"Reasonable steps" is not an entirely new benchmark; the FCA Code of Practice for Approved Persons refers, for example, to "reasonable steps" in a number of places, and states that "personal culpability" will attach to a breach where "the approved person's standard of conduct was below that which would be reasonable in all the circumstances".¹¹ What is new, however, is that this rather subjective-sounding standard has been combined with a new level of individual accountability; as such, it has become an area of focus for senior managers in connection with the SMCR.

Senior managers will note that each of SC1, SC2 and SC3 will require them to take "reasonable steps" to ensure that any business for which they are responsible is controlled effectively, complies with applicable regulation, and that any delegation of their responsibilities is overseen effectively. Understanding what this benchmark of "reasonable steps" means in practice will be key for SMFs, since demonstrating that they have met this standard on an ongoing basis will (at least in theory) provide them with protection against assertions by the regulator that they are directly responsible for compliance failures within a sector of the business that is under their control.

What does the standard mean in practice?

In considering how SMFs can help ensure they meet the reasonable steps standard, it is helpful to refer to the FCA's Decision Procedure and Penalties Manual ("**DEPP**"), which provides an indication of how the FCA would approach this standard in an enforcement scenario¹².

As background, the FCA is able to take action against senior managers under DEPP where they have breached a "duty of responsibility"; namely, where the FCA can show that there was misconduct in connection with activities that the SMF was responsible for overseeing, and where the SMF "did not take such steps as a person in their position could reasonably have been expected to take to avoid the misconduct occurring or continuing". DEPP 6.2 sets out a number of criteria that the FCA would expect to

¹⁰ See page 65 of FCA Policy Statement 18/14.

¹¹ See APER 3.1.4.

¹² See PS 18/61 on the Duty of Responsibility for insurers and FCA solo-regulated firms, which indicates that solo-regulated firms will need to refer to DEPP once the SMCR has been phased in in December.

take into account in determining whether an SMF has taken “reasonable” steps in this regard. These include in particular:

- whether the SMF exercised reasonable care when considering any available information, and whether they then reached a reasonable conclusion on which to act;
- the nature, scale and complexity of the firm’s business, and the SMF’s role within it;
- the knowledge the SMF had, or should have had, of regulatory concerns relating to his or her role and responsibilities, and whether the SMF acted in accordance with their obligations under the general legal framework (e.g. under the Companies Act 2006 and the FCA Handbook);
- whether the SMF took reasonable steps to:
 - ensure that actual or suspected issues were dealt with in a timely and appropriate manner;
 - ensure that any delegation of their responsibilities was to an appropriate person with the necessary capacity, competence, knowledge, seniority and skill;
 - effectively oversee the discharge of any delegated responsibility;
 - ensure that reporting lines, whether in the UK or overseas, were clear to staff and operated effectively;
 - satisfy themselves that the firm had appropriate policies and procedures for reviewing the competence, knowledge, skills and performance of each individual member of staff to assess their suitability to fulfil their duties; and
 - assess and monitor the effectiveness of the governance, operational and risk management arrangements in place for the firm’s activities for which they were responsible.

Practical issues: compliance with Conduct Rules

Based on guidance from the FCA, what steps should SMFs be seeking to take?

The following considerations will be relevant in helping SMFs to assess whether they are meeting the reasonable steps standard:

- **Taking into account their Statement of Responsibilities, the SMF should assess whether they feel satisfied that they are receiving the necessary information flow from those divisions of the firm whose activities are under their oversight.**
 - For example, are issues that arise on the “front line” (e.g. on trading desks) effectively escalated to senior management where this is appropriate? How quickly does this escalation occur in practice? Are trading teams able to effectively distinguish when to escalate an issue and when this may not in fact be required?
- **When assessing the proportionality component of the rules, SMFs should consider not only the number of staff employed by the firm and the potential impact on underlying investors, but also the complexity of the firm’s trading strategies and the potential scale of the impact that those trading activities could have on the market.**
 - These points will all play into the factual background against which the FCA will assess the reasonableness of an SMF’s actions, and are particularly important for hedge funds, which tend to be far smaller organisations than banks, but whose trading strategies can have a

significant market impact.

- In assessing risk more generally, SMFs should consider whether there are particular instruments traded by the firm that pose a greater compliance issue (e.g. around market abuse) as a result of practices in that particular market sector or a general lack of transparency (e.g. highly illiquid fixed income).
- **SMFs in asset management firms should pay particular attention to the fact that the FCA will have regard to “the knowledge the SMF manager had, or should have had, of regulatory concerns relating to their role and responsibilities”.**¹³
 - Staying on top of regulatory developments affecting markets and trading issues, firm governance and data protection has become increasingly challenging in recent years given the sheer quantity of new financial services regulation. This is particularly the case for individuals working in smaller compliance teams.
 - Each SMF must therefore consider how exactly they are currently staying on top of regulatory developments affecting their sector of the firm, and the balance that needs to be struck between knowing and understanding the regulatory framework themselves and feeling confident that they are delegating responsibilities to others that are reliably able to detect and identify concerns around compliance issues.
 - Staying on top of those FCA supervisory priorities that are relevant to the SMF’s management responsibilities, will, in particular, be essential.
- **Managing delegation will be key.**
 - Prior to the entry into force of the SMCR, SMFs should consider who within the organisation they currently delegate responsibilities to.
 - SMFs will not only need to ensure that they delegate responsibility solely to those individuals who possess the necessary qualifications and expertise to undertake the delegated role, but also that they effectively oversee the manner in which the individual carries out the delegated responsibilities.
 - Effective oversight will take different forms depending on the responsibility being delegated, but should include at least:
 - regular update meetings;
 - an effective upwards reporting mechanism; and
 - a robust review and appraisal process in relation to the delegate.
- **Reporting lines must operate effectively.**
 - As a first step, reporting lines should be documented.
 - However, SMFs will also need to ensure that they are working as intended; for example:
 - someone should be in charge of keeping documented reporting lines up to date; and
 - effective procedures should be put in place to deal with the situation where someone is in another timezone or simply uncontactable.
- **SMFs should consider whether they are currently in a position to assess and monitor the firm’s governance, operational and risk management arrangements.**

¹³ See DEPP 6.2.

- In ensuring that this standard is met, a review of the firm's governance structure may need to be undertaken in the lead-up to implementation (to the extent that this has not been done recently).
- Putting together a "live" responsibilities map would greatly assist with this assessment, even though it is not strictly required for Core firms.
- **Finally, SMFs should consider whether they are getting the necessary information around operational and risk management, and engage with their risk committee if there is one.**

Based on guidance from relevant caselaw, what steps should SMFs be seeking to take?

- The Pottage case,¹⁴ which is often cited in connection senior manager responsibility, provides some helpful pointers on governance strategies that may assist SMFs in those cases where there has been a conduct or compliance breach in an area under their supervision.
- The following steps were all identified in Pottage as "good" practices for senior managers to take on board:
 - frequent meetings with clear roles assigned during those meetings;
 - clear terms of reference for committees involved the firm's governance;
 - performing a root cause analysis for any issues identified; and
 - ensuring that any issues raised are effectively tracked over time.
- Pottage also highlighted the need for senior managers to focus on the initial handover process when they first take a role on. In particular, senior managers should aim to understand any issues that arose during the previous manager's tenure, and how they were resolved.
- Despite the clear importance of good governance standards, we know from previous FCA enforcement actions that it is not an adequate defence for senior managers to simply act in accordance with their firm's governance arrangements in cases where they nonetheless fail to show that they had adequate oversight of their area of the firm's business, or to ensure that any relevant systems and controls were adequate in nature¹⁵.
- Based on Pottage, however, senior managers can protect themselves from missing key information around the functioning of their firm's operational or risk management framework by ensuring that the correct management information reaches them.
 - In particular, management information should function effectively as an early warning system of potentially broader compliance issues within the organisation.
 - This may require a "root cause" analysis of any issues that are reported upwards to senior management level, which may in turn necessitate a broader review within the organisation.
 - In addition, where senior managers are put on notice of an issue within the organisation, they should not only consider next steps; they should also consider how efficiently the information reached them and whether the issue should have been caught sooner.

¹⁴ John Pottage v The Financial Services Authority.

¹⁵ FSA v Peter Cummings.

Required Documentation

The new Conduct Rules framework will require revisions to a number of internal policies. For example:

- A policy around internal reporting of Conduct Rule breaches and subsequent notifications to the FCA will need to be drafted.
- Adjustments may need to be made to the firm's decision-making and governance framework, its committee terms of reference, and any policies governing the collation and provision of management information.
- Disciplinary procedures may need to be revised in light of the Conduct Rules, and the firm may also wish to revisit its whistleblowing and ethics policies to ensure that they meet the required standards.
- SMFs may wish to see new or revised internal policies produced on delegation of duties and handover procedures.
- The firm's training policy will need to be revised in light of the Conduct Rules.

SECTION 6

ASSESSING FITNESS AND PROPRIETY

Timing: Build SMCR requirements into fitness and propriety assessments from 9 December 2019

Under the SMCR, firms must assess the fitness and propriety of individuals acting either as Senior Managers or as Certified Employees (including any non-executive directors), at least on an annual basis. This will involve an assessment of both their conduct and competence in the role.

In general, the FCA has not placed prescriptive requirements on how firms should carry out fitness and propriety assessments on an ongoing basis, given that, in the FCA's view, regulated firms themselves are best placed to decide how their internal employee assessments should be carried out. However, the FCA has reiterated that the core aspects of fitness and propriety are: (i) honesty, integrity and reputation; (ii) competence and capability; and (iii) financial soundness¹⁶.

The FCA has also noted that firms may make fitness and propriety assessments in a proportionate manner; in other words, firms may adapt the criteria for fitness and propriety to each individual's role. Thus, where a junior trader practises under supervision, they can be certified as fit and proper for the Client Dealing Function on the condition that they meet certain basic standards and are supervised.

Practical issues: fitness and propriety

- Firms will need to consider how to align fitness and propriety assessments with their appraisal process. Attempting to certify fitness and propriety months after an appraisal could be problematic, given the potential for issues to have arisen in the months following the appraisal.
- Firms should also bear in mind that if a certification cannot be made, the Certified Employee will need to cease performing the certified role. They may, for example, need to be temporarily deployed in another part of the business. Policies and procedures should be drafted to deal with this outcome. Similarly, appraisal forms, employment contracts and employee handbooks will likely need to be revised.
- When firms are assessing whether SMFs are fit and proper to perform their role, in connection with the SMF's application for approval, they must undertake a criminal records check (note that this requirement also applies to non-executive directors who are not SMFs). In practice, this means that firms will have to register with the Disclosure and Barring Service ("**DBS**") if they have not previously done so¹⁷.

Required Documentation

Revised procedures for the assessment of fitness and propriety, both at the point of recruitment and at least annually thereafter.

Appraisal procedures may need to be revised.

¹⁶ See page 36 of FCA Policy Statement 18/14.

¹⁷ See page 40 of the FCA SMCR Guide for FCA solo-regulated firms.

SECTION 7

REGULATORY REFERENCES AND THE FCA DIRECTORY

Timing: Begin compiling regulatory reference data from 9 December 2019

Under the SMCR, all firms will be required to provide a regulatory reference in relation to any current or former employee's fitness and propriety, where the individual in question was employed by the firm at any time within the last six years, and where he or she is taking on a new role as either a SMF or as a Certified Employee. These regulatory references must be provided on a standard form template that sets out:

- details of the function held by the individual;
- details of any Conduct Rule breach within the last six years (unless the breach amounts to serious misconduct, in which case there is no time limit on disclosure);
- any finding over the last six years that the individual was not fit and proper to perform a function;
- any disciplinary action taken against the individual; and
- whether the firm is aware of any other information that it reasonably considers to be relevant to fitness and propriety.

HOW MUCH OF A STEP UP IS THIS FROM THE CURRENT REGIME?

Given that banks and other PRA-regulated firms have been required to request these references for some time now, asset managers may already have had to put them together. In addition, there are already rules in place for asset managers around giving references under the Approved Persons regime. However, there are a few significant changes to the current framework, as follows:

- firms must request a reference from all previous employers in the past six years for Senior Managers, Certified Employees and Non Executive Directors; this effectively means that an employer will need to provide a regulatory reference to each new firm their former employee moves to over a six year period;
- as noted above, firms will need to provide references using a standard template; and
- firms must update regulatory references if new information comes to light (see below).

UPDATING REFERENCES

If new information about a former employee's conduct comes to light after the individual has left a firm, the firm must update the individual's new employer. The test for assessing whether an update is required is:

- whether the new information would have caused the firm to have written the original reference differently had it been known at the time; and
- whether the new information would change an assessment of the fitness and propriety of the individual.

DEADLINE FOR RESPONDING TO REFERENCE REQUESTS

The FCA has indicated that it expects firms to respond to requests for regulatory references within six weeks.

TIMING FOR MAKING A REFERENCE REQUEST

The FCA has provided some guidance on the situation where a candidate has not yet informed their current employer that they are leaving, noting that:

- for SMFs, firms should ideally get references before they submit an application for approval. However, where this is not possible, firms can get references no later than one month before the end of the application process; and
- for Certified Employees, firms must receive the references before they issue a certificate under the Certification Regime.¹⁸

FCA DIRECTORY

Once the SMCR regime has been phased in, only Senior Managers will appear on the FCA Register; other persons performing Certified Functions that would originally have been controlled functions will no longer be added. In order to ensure that the industry has a means of publicly accessing information about the identity of such individuals, the FCA has proposed setting up a new “Directory”; i.e. a general register of information about individuals who are active in the financial services sector¹⁹. This Directory will not simply include Certified Employees such as portfolio managers and traders, but will go beyond the scope of the SMCR to include Appointed Representatives.

Firms should be aware that once the Directory goes live, it will be their obligation to upload and keep information on the Directory up to date. Indeed, the responsibility for doing so will ultimately rest with a SMF (see our [Timeline](#) for implementation timing).

Practical issues: Regulatory References

(A) Preparing regulatory references

- From the outset of the regime, firms should begin to compile regulatory references in the correct format. In due course, this data will need to go back six years.
- Given the potentially serious consequences of the reference for the individual involved, firms will need to carefully consider how to demonstrate that they have exercised due care in the preparation of references, and that they have behaved fairly towards the employee concerned. The following issues should, in particular, be thought through prior to December 2019:
 - Under the general legal framework, firms will need to continue to ensure that references are true, accurate, and fair. The required format for regulatory references, however, requires clear and affirmative responses to the various issues required to be covered, so there will in future be limited scope to remain either silent or neutral on conduct related issues.
 - Firms can help to ensure that the reference process is fairer and more objective by thinking carefully about the steps that precede finalising the regulatory reference.
 - In particular, firms should ensure that any allegations against an individual are thoroughly investigated before being included in the reference, and that they give

¹⁸ See page 40 of FCA Policy Statement 18/14.

¹⁹ See PS19/7.

the employee a chance to comment on the information before finalising it.

- In other words, the employee concerned should have been sufficiently involved in the process that the finalised reference does not come as a surprise.
- Tricky issues will also arise where:
 - a conduct issue is revealed following an individual's departure from the firm, and where they are not then able to comment on its inclusion in the reference; or
 - allegations of misconduct have been made but the individual in question has left the firm before they can be fully investigated.
- In preparation for the introduction of the regulatory referencing regime, firms should also:
 - consider how they can assess fitness and propriety to an acceptable level in situations where a potential new hire has previously worked for unregulated or overseas firms, which are not required to provide regulatory references (the FCA has, for example, suggested that local criminal records checks should be carried out for any SMFs that have worked overseas in the last six years)²⁰;
 - consider what parameters may be needed around the firm's tolerance for hiring in situations where conduct issues have been revealed by the regulatory referencing process; and
 - ensure that the firm's employment or partnership contracts do not, for example, conflict with the regulatory referencing regime. As under the current regime, firms may not enter into non-disclosure agreements that conflict with their obligation to provide references.

(B) Record keeping

- Given that firms will need to provide regulatory references for up to six years following an employee's departure, it is important that they have clear policies in place to retain the necessary records during this period.
- Firms will also need to bear in mind that there is no time limit on providing information relating to serious misconduct, so they will need to put in place a policy describing what such misconduct could be, and ensuring that it is retained even after regulatory references have been destroyed.

(C) GDPR issues

- The FCA has expressed the view that "the requirement to provide a regulatory reference does not contravene any aspect of the GDPR", given that the information employers are required to give is proportionate and storage of the information is "for an appropriate amount of time"²¹.
- Nonetheless, firms will likely wish to perform some level of GDPR impact assessment (particularly in relation to the requirements around serious misconduct, which do not appear to be time limited). For example, firms will need to ensure that any data processed in connection with the referencing requirements is done in a way that ensures appropriate security of the personal data.
- The potential for former and current employees to make GDPR subject access requests should also be anticipated and considered.

²⁰ See page 37 of FCA Policy Statement 18/14.

²¹ See page 41 of FCA Policy Statement 18/14.

Required Documentation

Firms should have a regulatory referencing policy in place prior to the commencement of the SMCR regime, dealing with:

- recordkeeping and the ongoing collation of data required to go into regulatory references;
- the appropriateness of information to be included in regulatory references; and
- procedures for obtaining regulatory references for new Certified Employees etc.

Amended language may also be required for:

- standard employment contracts; and
- disciplinary policies and procedures.

Recruitment policies may need to be revised.



SMCR IMPLEMENTATION TIMELINE

Now – May 2019

Review existing FCA filings and approvals, and make any necessary amendments well in advance of the commencement of the SMCR.

Calculate Assets Under Management in line with SMCR, to identify whether firm is Core or Enhanced.

Review how internal reporting lines and firm management are currently structured, and evaluate how these existing procedures should be reflected in SMCR compliance policies.

May – September 2019

The FCA will likely contact firms at around this time with an assessment of their status under the SMCR (ie Core, Enhanced or Limited Scope). This assessment should be checked against the firm's own determination.

Ensure that all Senior Managers, Certified Persons and Conduct Rule Staff have been

Put together Statements of Responsibility and agree content with Senior Managers.

Draft Responsibilities Map (Enhanced Firms only).

Provide training to Senior Managers and Certified Persons.

September – 8 December 2019

Ensure that the roles of assessing Conduct Rule breaches and fitness and propriety have been assigned, and that the individuals involved understand their function.

Finalise revised documentation, including contracts of employment, employee handbooks, compliance manuals and any LLP Agreement. Write to staff to inform them of changes where necessary.

Finalise Statements of Responsibility.

9 December 2019

Begin compiling regulatory references.

Check approvals on the Financial Services Register and correct any inaccuracies as soon as possible.

By December 2020

Complete initial certification process.

Train non-Senior Managers and non-Certified Persons on the conduct rules.

Upload data on relevant individuals to the new FCA Directory.

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