Extending the Senior Managers Regime

A New Individual Accountability Regime for all FSMA Authorised Persons
Implementation Checklist

01 Senior Managers
011 Identify senior management functions (SMF) population
012 Allocate Prescribed Responsibilities (PR) and relevant business functions (e.g. executive director, SMF3)
013 Identify any shared PR or function and consider whether appropriate
014 Distinguish between “Approved” non-executive directors (NEDs) - i.e. Board Chairman, Board Committee Chairs who must be pre-approved by the regulator and those merely requiring notification or “Notified” NEDs
015 Draw up and issue a Management Responsibilities Map showing allocation of PRs

02 Senior Manager: Statements of Responsibilities (SoRs)
021 Review & agree SoRs with relevant manager
022 Submit SMF applications to FCA for pre-approval (where no grandfathering available)
023 Review & amend executive service agreements to reflect SMR regime
024 Review approved NED letters of appointment

03 Mapping & Governance
031 Review terms of reference for the board, its committees, and reporting lines
032 Review management structure / reporting lines in view of PR
033 Review delegation and escalation policies
034 Review adequacy and quality of management information
035 Review management practices around record-keeping and decision making audit trails
036 Develop procedures around senior manager handovers
037 Identify all entities in a group that are caught by the SMR

04 Certified Persons
041 Identify Certified Person population
042 Identify Material Risk Takers
043 Identify functions requiring qualifications/customer facing
044 Identify any managers of Certified Persons
045 Review & amend contracts of employment to reflect certification and Conduct Rules
046 Communicate regulatory requirements to Certified Person population
047 Carry out fit and proper assessments and certify accordingly
048 Put in place procedures to re-assess fitness and propriety on an annual basis

05 Conduct Staff
051 Identify and exclude ancillary staff
052 Review & amend contract of employment to reflect Conduct Rules

06 HR & Training
061 Review & consider impact of SMR on HR policies and procedures
062 Consider, if relevant, any clawback or malus rules on senior manager remuneration
063 Carry out GAP analysis for certification process and referencing on recruitment
064 Amend & update employee handbook policies and terms and conditions of employment
065 Confirm whistleblower policies comply with FCA requirements/best practice
066 Design and deliver training as relevant to specific categories of staff/contractors
Senior Managers Regime Time Line

June 2013
Report of Parliamentary Commission on Banking Standards recommending a senior managers regime (SMR).

October 2015
HM Treasury paper announces extension of SMR to all FSMA authorised firms.

4 May 2016

7 March 2016
Initial SMR roll-out for banks, building societies, large investment firms and credit unions (Relevant Authorised Persons).

7 September 2016

7 March 2017

2018
Extension of SMR to all FSMA authorised firms.

Quarter Two 2017
FCA expected to consult on extending SMR and to publish draft rules.

June 2013
Financial Services Banking Reform Act 2013 - enacts SMR.
Overview

7 March 2017 marked the first anniversary of the initial roll out of the Senior Managers Regime (SMR) to those holding senior management functions in banks, building societies, larger investment firms and credit unions. Firms outside the scope of the initial waive of firms subject to the SMR will soon have to grapple with the implications of the SMR.

The feedback from firms is that the SMR has made a real difference to the way in which the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) regulate banks and similar entities within the scope of the SMR. In a speech on 19 January 2017, Mark Steward, FCA Director of Enforcement and Market Oversight, stated that the SMR imported a “notion that senior managers have obligations to act reasonably to prevent misconduct by [a] firm from occurring” and that “the regime embraces a very simple proposition – a senior manager ought to be responsible for what happens on his or her watch.”

The Bank of England and Financial Services Act 2016 provides for the extension of the SMR to all Part 4A FSMA authorised firms. This was consulted on by HM Treasury in their October 2015 paper. Based on the current understanding of the proposals, authorised payment institutions and e-money issuers will therefore fall outside of scope as non-FSMA authorised firms. Consumer lenders or insurance intermediaries, however, will be in scope. The extension will replace the Approved Persons Regime in its entirety, thereby reducing regulatory complexity and, for regulators, shifting the burden of assessing as fit and proper a large number of staff (below senior management level) to the industry itself. This step makes sense given that the regulated community has grown by 30,000 firms with the transfer of consumer credit regulation to the FCA in April 2014.

The FCA is due to consult the 50,000 plus firms affected by its proposals this year, in readiness for implementation during 2018. HM Treasury has promised that the extended regime will be tailored to reflect the diverse business models in the UK market and be proportionate to the size and complexity of firms. There is a precedent in that the SMR also applies to branches of overseas banks, but in a modified form, depending on whether they are EEA or non-EEA firms. Concessions have also been made to small institutions with assets under £250 million. For this reason, there is good reason to provide feedback when the FCA consults with a view to better shaping the regime.

Key Elements of SMR and Certification Regime

The SMR replaces the Approved Persons Regime, the key elements being:

1. Senior Management Function Holders (SMFs)
   Board members and other individuals who hold key roles or have overall responsibility for specific business areas, functions or activities within the firm require pre-approval by the PRA or FCA (depending on the function being performed).

2. A Certification Regime for Significant Harm Function Holders
   These individuals do not require regulatory approval but need to be certified by the regulated firm, which must assess their fitness and propriety. The regime captures most individuals other than SMFs who would have been subject to the current Approved Persons Regime. Certified persons generally comprise the next management rung down from senior managers plus certain technical and customer-facing functions.

3. Conduct Rules / COCON
   These are high level requirements replacing the existing Statements of Principle and Code of Practice for Approved Persons. From 7 March 2017, the Conduct Rules will apply to all staff except for those in purely ancillary roles (e.g. receptionists), though initially only to those caught by the SMR and Certification Regime. If an individual is disciplined for a breach of the Conduct Rules the regulator must be notified.

4. Statements of Responsibilities (SoRs)
   Under the SMR, a SoR must be drawn up and provided to the regulator. It must clearly describe the responsibilities that the senior manager is to perform as part of their function and how they fit in with the firm’s overall Management Responsibilities Map. The description should not exceed 300 words for each responsibility given to a Senior Manager. If the SoR is updated the regulator must be notified. Where there is a regulatory contravention by a firm the relevant regulator will wish to see within whose area of responsibility it has occurred.
Extending the SMR

Applying the SMR to just banks, building societies and large investment firms created an inconsistency with other FSMA firms. These other firms have remained subject to the "discredited" Approved Persons Regime. It was therefore inevitable that the SMR would be extended to other FSMA firms. The main changes for firms under the new regime will be that:

• their senior managers will be subject to a more bespoke regime under which their responsibilities will be clearly identified and articulated. This will encourage those exercising senior manager functions to take more interest about what is happening on their watch; and

• other key individuals will fall under the Certified Persons regime. Firms will need to take more responsibility for ensuring that those individuals will be fit and proper.

Although the regime is likely to be applied to new firms in a "proportionate" manner, the practical and cultural changes required should not be underestimated. On the one hand, firms will need to establish processes to implement these changes. On the other hand, the bigger picture drive is to bring about a change in firms’ culture. We describe below the main areas requiring consideration by firms in planning and preparing for the roll out of SMR in 2018.

The FCA's consultation paper on the extension is expected to be published in the first half of 2017. Implementation will take place during the course of 2018, possibly on a sector by sector basis.
Implementation Considerations

Statements of responsibilities (SoRs)

Under the SMR, firms must identify and allocate 30 prescribed responsibilities to senior managers which must be described in a SoR preferably no longer than 300 words. The evidence of the last 12 months shows that SoRs are making senior managers focus on their prescribed responsibilities and more conscious of taking on responsibilities outside these. Proponents of the regime claim that it is helping to identify weaknesses in governance and accountability and encouraging the necessary changes.

In its forthcoming consultation paper, the FCA is likely to provide more detail on how it proposes to apply prescribed responsibilities and SoRs to new firms – probably in a more light touch manner for smaller, less complex businesses. The modified application to small institutions and to foreign bank branches with limited senior management functions and prescribed responsibilities may show the way.

Although the detail is not yet known it is possible to start work on revising the job descriptions of senior management and revisiting existing governance maps.

When considering what is required of firms it is helpful to refer to feedback from the FCA. In September 2016, the FCA published the findings of its review of SoRs and responsibilities maps supplied by firms. It acknowledged that firms had engaged with the process and invested time in their preparation. In most cases it considered they had correctly identified senior managers and allocated SMFs and responsibilities appropriately. There were, however, various issues which led the FCA to consider that some firms might not have fully understood the SMR and, therefore, had failed to implement it correctly. The lessons learnt included:

- instances where it was unclear if a firm had identified sufficiently senior individuals to hold SMFs (e.g. one SMF reporting to another or having insufficient seniority to carry out their obligations);
- cases where it was unclear if all relevant business functions and activities had been allocated, in particular, where responsibilities were shared or divided between managers;
- some firms did not provide enough detail in their SoRs and maps to specify the scope of an individual’s responsibilities;
- a wide variation in the quality of management responsibilities maps and the omission of key information; and
- especially, as regards firms that were part of a larger group, supplying insufficient information about how a specific firm’s management and governance related to the group, thus making it difficult for supervisors to understand how it was run in practice.

Duty of responsibility

When the SMR was first conceived of, it was intended to place the burden of proof on a senior manager to show that he was not at fault for a regulatory contravention by the firm occurring within his area of responsibility. This was seen as unfair and in response to the outcry which followed the Government has changed its policy. The 2016 Act amended the law to introduce what is referred to as the “duty of responsibility”. Senior Managers are now held accountable if they fail to take reasonable steps (including training or proper oversight) to prevent or stop regulatory breaches in their areas of responsibility.

This is similar to a form of negligence and to an extent reflects existing case law and regulatory duties. However, as it is now articulated in statute and coupled with the SoRs, it is generally considered that senior managers are at greater risk of disciplinary action when things go wrong on their watch.

Given the above, management must be briefed on reviewing their practices on record keeping and on maintaining an audit trail of their decision making should they have to justify their stewardship to the regulators. It is particularly important for them to be able to explain and document why they took (or did not take) a particular course of action, and how they kept themselves properly informed through management information. Trying to do so several years later without written records during an investigation would be difficult.

Handover certificates

The SMR requires that incoming managers are properly briefed especially as regards conduct risk (that is the risk of customer detriment). In this context, an out-going manager might provide a handover certificate confirming and detailing the regulatory risks to which that part of the business is exposed and any action taken (or an explanation of why no steps were taken). It is likely that a similar requirement will be imposed on firms coming under the regime in 2018 and it would be sensible to plan ahead. Potential steps might include devising a policy towards handovers, including regular updates to such a document (like a form of “living will”), should a manager leave unexpectedly. Contracts should be reviewed and revised to make this obligatory.

Certified Persons

Under the SMR, firms need to identify those persons who, in general terms, comprise the next management rung down from senior managers, plus some technical and customer-facing roles which, in the language of the regulations, might cause “significant harm to customers” and the market. Given the “proportionate” application of the regime to new firms, which may be smaller and less complex than existing scope firms, it is not yet clear which employees will be affected although it is likely to cover (where relevant) any “material risk takers” or Remuneration Code Staff.

Such persons need to be certified by firms themselves as fit and proper to perform their role on an annual basis. Administratively, this is best done in conjunction with an individual’s annual performance review. While this will represent a significant change as the FCA currently “signs off” on Approved Person applications, in reality firms today have to make inquiries of an individual and reach a view on their suitability. The availability of regulatory references (see below) from other financial services firms will be of help to those hiring, but in contrast to pre-approval for senior managers by the regulators, a criminal records check will not be mandatory. Firms will need to be ready to justify their conclusions if called upon by the FCA, not simply at the time of hiring but on a continuing basis.

In the meantime, those charged with implementation should consider if their HR and compliance processes are adequately aligned to assess and, if appropriate, issue annual certificates. The practice to date for existing SMR firms has been to co-ordinate this process with the annual performance review. HR policies and employment contracts should be reviewed to ensure they are compatible and allow for dismissal (or other appropriate action) where a firm concludes that it cannot issue a certificate.
Fitness & Propriety

In February 2017, the Banking Standards Board published Statements of Good Practice and supporting guidance. The statements and guidance are designed to help banks and building societies put in place procedures to assess the fitness and propriety of staff under the Certification Regime. The practical guidance is said to reflect the knowledge and experience of firms to date. The statements and guidance should also be helpful to the rest of FSMA authorised firms when the regime is extended next year.

Conduct Rules

The Conduct Rules or COCON have replaced the Statement of Principles for Approved Persons (APER) for existing SMR firms and are likely to be rolled out to all authorised firms. It is worth bearing in mind that, unlike the Statement of Principles, which only apply to Approved Persons, the FCA will apply COCON to all staff (except for ancillary staff). It would be advisable to prepare communications about the new regime and training sessions for the wider body of employees in 2018. A new aspect of COCON in contrast to the Statement of Principles is the inclusion of a new Treating Customers Fairly (TCF) rule which binds all Code staff and provides that: “[staff] must pay due regard to the interests of customers and treat them fairly.” Currently, this obligation applies only to firms under the FCA’s Principles for Businesses.

The effect of these rules is to subject a much wider body of persons to regulatory rules and potential disciplinary action. The staff handbook and contracts for service with contractors should require observance of them. Where disciplinary action is taken for a breach, the appropriate regulator must be notified.

Firms should consider how their systems and processes would work with internal disciplinary procedures, as well as capturing and reporting this information. In this respect, the complementary rules on regulatory references are relevant.

Regulatory references

New rules on regulatory references are in force for existing scope SMR firms. These have the effect of significantly increasing the obligations on both outgoing and new employers when hiring staff with a view to stopping so called “rotten apples” from moving from firm to firm.

The rules apply not only to senior managers but also to certified persons. From 7 March 2017 (when these rules came in to force), a hiring firm needs to obtain references which cover the candidate’s employment history for the last six years (although there is no time limit in the case of serious misconduct). These references will need to be in a prescribed format (if provided by a SMR firm) with mandatory disclosures and must be provided before the individual starts work. Additionally, there will also be a continuing duty on a SMR firm to provide an update for up to six years where it becomes aware of matters which would have caused them to draft the reference differently. An area of difficulty is the position where an employee leaves before the alleged misconduct has been investigated and there is no conclusion. A decision will need to be taken over what, if anything, should be included in those circumstances.

Authorised firms not yet within the scope of SMR will nonetheless be required to provide regulatory references disclosing all information which they reasonably consider to be relevant, up to six years previously (except in the case of serious misconduct when there is no time limit). Otherwise these rules represent best practice. With the extension of the SMR, they may in due course apply fully to all (or more) authorised firms. It is essential therefore that businesses have procedures in place to record and to promptly provide regulatory references when requested.

Do remember that all firms providing references will be still be subject to common law duties of care and liable for defamation to their former staff, but not providing a reference will cease to be an option; nor will it be possible to give a purely formal statement.

Whistleblowing

Since September 2016, banks, building societies, large investment firms and insurers have had to establish and maintain an independent whistleblowing channel through which staff (and others) may make disclosures. There is also a duty on them to appoint a “whistleblowers’ champion” who is a senior individual with responsibility for the effectiveness of whistleblowing arrangements. Please note that staff may also whistle blow to regulators directly.

For other authorised firms, these arrangements simply represent best practice. However, they may be extended in some form more widely and businesses should consider the adequacy of their present arrangements and what changes might helpfully be made in anticipation.
Key points to consider

Until the FCA publishes its proposals for implementation later this year it is not possible to engage in detailed planning. Nonetheless, as the regime has already been rolled out to the largest firms, the structure and key elements are well known. It therefore makes sense to begin preparing for implementation. We set out some matters to consider:

• Take steps to ensure that managers, HR and compliance are aware of the likely changes and put in place an implementation team;
• Review your governance structure including the roles of non-executive directors, lines of responsibility and job descriptions for senior management to ease the implementation process in 2018. It may be possible to “grandfather” current Approved Persons to Senior Manager or Certification roles;
• Consider how the regime will impact on recruitment, annual reviews, training and HR procedures (e.g. disciplinary action);
• Consider the impact of increased individual responsibility on the behaviour of senior managers (e.g. potential increased risk awareness and/or expression of dissent);
• Consider the position where functions/activities are outsourced; and
• Plan how to communicate the changes and train staff generally.
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