ALLEN & OVERY

The UK Senior Managers and Certification Regime

Themes, trends and challenges from the first three years

March 2019

"The vast majority of firms look back and say that implementing the SMCR was a positive move for them. Although some firms had to have difficult conversations with employees during their implementation projects for a variety of reasons, firms that have embraced the SMCR feel that their governance arrangements are now much stronger and clearer, especially at senior management levels."

Calum Burnett, Partner – Allen & Overy

Reflections on the first three years of the Senior Managers and Certification Regime

'A complex and confused mess'. These were the words used by the Parliamentary Commission on Banking Standards in 2013 to describe the UK's approved persons regime. It was this criticism that gave rise to the introduction of the Senior Managers and Certification Regime (the **SMCR**) for banks, building societies and PRA investment firms in the UK in March 2016.

Fast-forward to March 2019, and the SMCR has been in force for three years. During this period, industry trends and standards of best practice have emerged in key areas, such as fitness and propriety assessments, handovers between Senior Managers and regulatory references. Firms have also had to grapple with a number of post-implementation challenges along the way, especially in relation to the management of employee misconduct under the SMCR and the FCA's more recent focus on 'non-financial misconduct'.

The extension of the SMCR to approximately 47,000 other firms that are authorised by the FCA under the Financial Services and Markets Act 2000 in December 2019 will create a level playing field across the UK financial services industry in relation to individual accountability requirements and expectations. These firms will benefit from the experiences of and lessons learned by firms that are already subject to the SMCR.

In this briefing, we reflect on some of the key themes, trends and challenges that firms have faced since the implementation of the SMCR in the UK. These reflections draw on our extensive experience in this area, most notably our insights from having advised over 35 international banks in relation to the full range of implementation and post-implementation SMCR issues, as well as our work with various industry bodies on this topic.

Since its introduction in 2016, the SMCR has been closely observed by regulators in other jurisdictions. This has led to a number of other regulators introducing or proposing their own individual accountability regimes, most notably in Australia, Hong Kong and Singapore. These individual accountability regimes have been closely followed members of our Individual Accountability Working Group, and an overview of these regimes is set out on pages 38-39.

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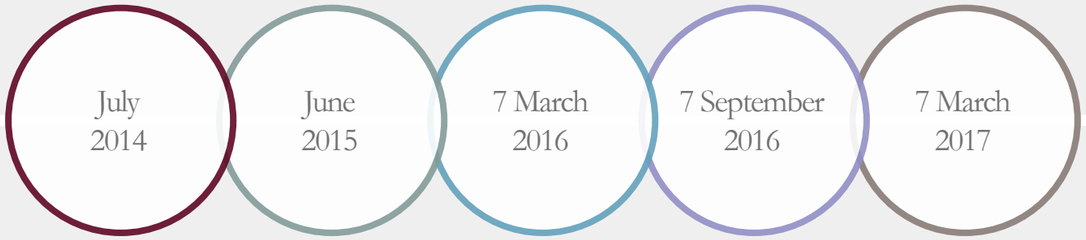
"Most firms have found that operating the SMCR in practice has taken much more time and resource than they had originally anticipated. Most of the work in relation to the SMCR has fallen on Compliance and HR, with recruitment, training, fitness and propriety assessments and regulatory references proving to be particularly time-consuming."

Sarah Hitchins, Senior Associate – Allen & Overy

The SMCR: A view across the industry

The implementation of the SMCR



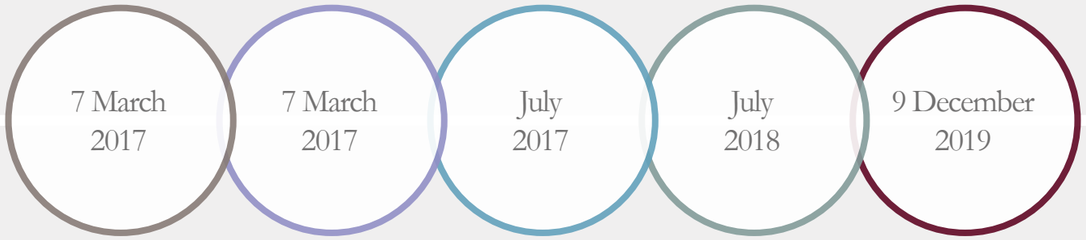
July 2014 – The FCA and the PRA announce their proposals for the SMCR.

June 2015 – The Fair and Effective Markets Review recommends that the SMCR is extended to cover all financial services firms operating in the UK.

7 March 2016 – The SMCR comes into force for banks, building societies and PRA investment firms.

7 September 2016 – The FCA and the PRA introduce new rules relating to whistleblowing arrangements.

7 March 2017 – Deadline for firms to complete their first annual fitness and propriety assessments for their Certified Persons.



7 March 2017 – The FCA's Code of Conduct starts to apply to all other employees (ie those who are not Senior Managers or Certified Persons), except those performing ancillary functions.

7 March 2017 – New regulatory reference rules come into force for firms that are subject to the SMCR.

July 2017 – The FCA publishes its proposals for extending the SMCR to all FCA-only authorised firms under the Financial Services and Markets Act 2000.

July 2018 – The FCA publishes its 'near final' rules for extending the SMCR to all FCA-only authorised firms under the Financial Services and Markets Act 2000

9 December 2019 – The SMCR will come into force for all FCA-only authorised firms under the Financial Services and Markets Act 2000

"There has been a raft of developments for firms to keep on top of since the SMCR came into force in March 2016. We hope that, after the SMCR is extended in December 2019, the regulators' basic requirements for the SMCR will remain consistent for the foresseeable future. However, we can expect more policy developments especially in relation to the regulators' expectations around culture and the handling of 'non-financial' misconduct."

Sarah Hitchins – Senior Associate, Allen & Overy

Further changes on the horizon

Since its introduction, the SMCR has not remained static. Several new Prescribed Responsibilities, as well as a new Senior Management Function (the SMF24 (Chief Operations)), have been introduced since March 2016.

Most recently, the FCA has consulted on the following changes to the SMCR:

HEADS OF LEGAL

Shortly before the SMCR came into force in March 2016, the FCA released a statement which was intended to address uncertainty in the industry as to whether Heads of Legal needed to be approved as Senior Managers. Heads of Legal had generally been excluded from their firms' populations of Senior Managers, unless they also performed another role such as Head of Compliance or Chief Operating Officer.

In January 2019, the FCA released a long-awaited Consultation Paper[1] on this issue. The FCA has proposed to exclude Heads of Legal from needing to be approved as Senior Managers, unless they perform another role which requires them to be approved as a Senior Manager. The FCA's rationale for this proposal was as follows:

"As so much of the Head of Legal's work relates to legal advice, the laws of legal privilege may restrict us, in practice, from using our powers over Senior Managers and carrying out our usual supervisory processes relating to Senior Managers, even in relation to the management parts of their job. As a result, the benefits that normally result from applying the SMR will be substantially reduced so that any remaining benefits are not sufficient to justify applying it."

[1] FCA CP 19/4.

NARROWING THE SCOPE OF THE CLIENT DEALING SIGNIFICANT HARM FUNCTION

The scope of the client dealing Significant Harm Function for the purposes of the Certification Regime is broader than the definition of the CF30 role that was used for the purposes of the approved persons regime. In particular, the Significant Harm Function includes individuals who have dealings with professional clients and eligible counterparties.

The FCA has received considerable feedback in relation to the scope of this Significant Harm Function, with many firms reporting that more junior staff who played purely administrative roles in relation to client dealings were caught by the Certification Regime. The FCA has acknowledged that this approach is: '*disproportionate (in terms of costs and administration) to the risks posed*' by these individuals.

As a result, the FCA is proposing to narrow the scope of this Significant Harm Function to exclude an individual who has no scope to choose, decide or reach a judgement on what should be done in a given situation, and whose tasks do not require them to exercise significant skill. This will allow firms to exercise judgment on whether a role requires an individual performing it to be caught by the Certification Regime. Relevant factors that firms would be required to consider in assessing whether an individual needed to be included in the Certification Regime include if the tasks that they perform are simple or large automated, as well as whether those tasks require an individual to exercise any discretion or judgement.

INTRODUCTION OF THE DIRECTORY

The industry reacted strongly to the more limited scope of the Financial Services Register (the **Register**) under the SMCR. While the Register had included current and historic details about all approved persons, under the SMCR current information was only available in relation to Senior Managers and not Certified Persons. As a result, current information about a significant number of individuals who are working in the financial services industry (ie all Certified Persons) is not available via the Register. Although it was suggested that a private third party company may decide to operate an expanded version of the Register, these plans did not materialise.

Last summer, in response to the feedback received by the industry, the FCA proposed introducing a new financial services directory (the **Directory**), which will replace the Register.

Importantly, the FCA proposed including Certified Persons in the Directory.
The FCA has confirmed its final rules in relation to the Directory and that it will be launched in or around March 2020. Although the introduction of the Directory has been welcomed by the industry, the Directory will bring with it more onerous obligations for firms. In particular, firms will be required to provide the FCA with more and updated information about a wider range of individuals that they employ.
In particular, as Certified Persons are not approved by the FCA or the PRA, firms will need to introduce new processes which allow them to notify and keep the FCA updated about their populations of Certified Persons within the quite short timeframes specified by the FCA, which is not something that they have been required to do since March 2016.

A snapshot of the SMCR across the industry[2]

- Approximately 5,000 Senior Managers are currently approved by the FCA and/or the PRA.
- The largest banks operating in the UK have on average 28 Senior Managers per legal entity.
- Third country branches operating in the UK have on average 12 Senior Managers per legal entity.
- 86% of Senior Manager applications have been approved by the regulators, with the remainder being withdrawn.
- Approximately 23% of current Senior Managers are women.
- Approximately 28% of Senior Manager applications have been made on behalf of female candidates.
- Approximately 47,000 additional firms will become subject to the SMCR when it is extended in December 2019.
- 1,106 disclosures from whistleblowers were received by the FCA in 2017/18.
- 11% of whistleblowing disclosures received by the FCA in 2017/18 led to further action being taken by the FCA, or were otherwise of significant value to the FCA.
- The FCA received 64 disclosures from whistleblowers in 2018 relating to 'non-financial misconduct', up from 20 in 2017.

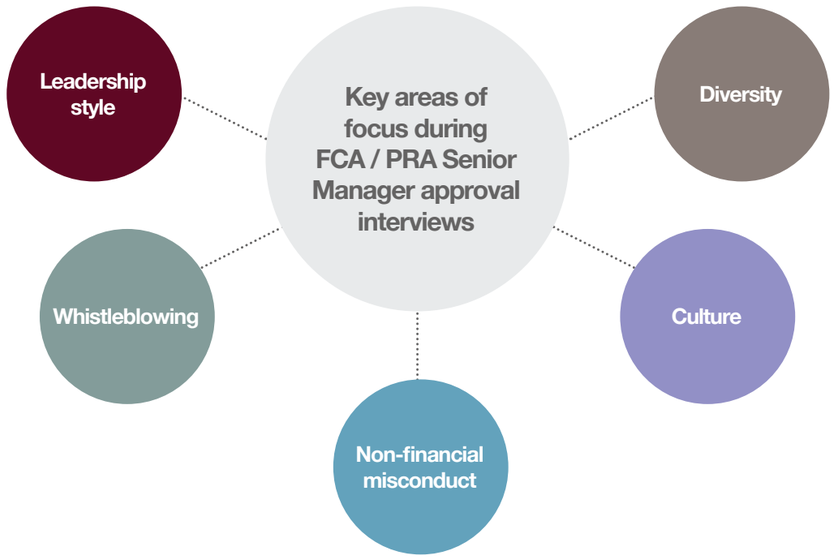
[2] Sources: Freedom of Information Act Requests submitted to the FCA and the PRA, research undertaken by Allen & Overy and FCA Annual Reports.

Regulatory approvals for Senior Managers

The process for having individuals approved as Senior Managers has remained largely the same as it was under the approved persons regime.

Although more information needs to be submitted along with an application for an individual to be approved as a Senior Manager, the FCA and the PRA have maintained a similar approach to deciding which candidates they wish to interview. As a result, it remains the case that not all candidates will be interviewed by the FCA and/or the PRA.

For those candidates who are interviewed by the FCA and/or the PRA as part of their approval processes, they should expect the regulators to take a different approach to their interviews than was previously the case. Candidates have reported being asked significantly more questions asking for their views on topics such as culture, leadership style, diversity, whistleblowing and how they consider non-financial conduct (see page 26) should be handled.



We have helped a number of clients' Senior Manager candidates prepare for their interviews with the FCA and/or the PRA, and have spent a considerable amount of time with them discussing their views and approaches in relation to these issues.

Conditional and time-limited approvals under the Senior Managers Regime have been used sparingly. They have typically been reserved for interim appointments to Senior Manager roles that are required because they are likely to last for longer than the regulators' '12 week rules' permit.

Handovers between Senior Managers

A new feature that was introduced by the SMCR was the requirement for firms to facilitate formal handovers between their Senior Managers.

In particular, a firm is required to take all reasonable steps to ensure that a person who is becoming a Senior Manager or a Senior Manager who is taking on a new job or new responsibilities or whose responsibilities are being changed, and anyone who has management or supervisory responsibilities for these individuals:

'has, when the [Senior Manager] starts to perform their new or revised responsibilities or job, all information and material that [they] could reasonably expect to have to perform those responsibilities or that job effectively and in accordance with the requirements of the regulatory system'.[3]

The information provided in a handover should be *'practical and helpful and not just a record'*, include an '*assessment of what issues should be prioritised*' and should also *'include judgement and opinion, not just facts and figures'*.[4] In particular, the FCA has said that the information that is included in a handover must include information about *'unresolved or possible breaches of the requirements of the regulatory system'* and *'any unresolved concerns expressed by the FCA, the PRA or another regulatory body'*.

One of the key challenges that firms have faced in relation to the preparation of handover materials is in relation to ensuring consistency, and ensuring that the information that is referred to above is captured in handover materials to the extent that it is relevant. Firms have sometimes found that the quality and granularity of handover materials have varied across business areas and control functions, with some Senior Managers receiving large volumes of detailed information and others receiving relatively little information. In response to these observations, firms have taken steps to require handovers to adhere to a standard format.

The FCA and the PRA expects firms to take reasonable steps to ensure that an outgoing Senior Manager contributes to the handover materials that a firm prepares. They are expected to contribute the information that they would consider to be relevant, including their opinions on key issues. In most cases, getting this input from outgoing Senior Managers has been possible without causing any issues. Most Senior Managers realise that participating in a clear and thorough handover of their responsibilities is in their best interests, and also goes towards their compliance with the 'FCA/PRA Code of Conduct and their ability to discharge the Duty of Responsibility. However, in a small number of cases it has proved more challenging to secure the input of outgoing Senior Managers into their handover materials. This is particularly so in circumstances where Senior Managers may be leaving their role quickly or in difficult circumstances. In order to help mitigate the risk may not be able or willing to contribute to their handover materials, a number of firms require their Senior Managers to maintain handover documents as 'living documents'. Although these materials may need to be updated as and when they are required, this tends to be preferable in comparison to starting to prepare these materials from scratch.

[3] FCA Handbook, SYSC 25.9.4R.
[4] FCA Handboo, SYSC 25.9.7G.
[5] FCA Handbook, SYSC 25.9.6G.

When incoming Senior Managers receive handover materials, it is important that they review these materials carefully, ask questions and, where appropriate, challenge their contents. Taking this approach will help inform a new Senior Manager about what issues they should be prioritising in their new role. It also helps them to demonstrate compliance with the FCA/PRA Code of Conduct, and goes towards their ability to discharge the Duty of Responsibility. Particular areas that new Senior Managers should focus on are as follows:

- Understanding governance and risk frameworks.
- Reviewing risk thresholds and appetites.
- Familiarity with regulatory requirements and expectations.
- Understanding key personnel and HR issues.
- Identifying key initial priorities.
- Checking key policies and procedures.
- Reviewing delegation arrangements.
- Assessing adequacy of management information.
- Checking adequacy of and adherence to training requirements.

To the extent that handover materials or an incoming Senior Manager's subsequent enquiries uncover material issues or weaknesses, a Senior Manager must take appropriate steps to address these matters. An audit trail of the steps taken in these circumstances should also be maintained.

"The majority of handovers between Senior Managers run smoothly and outgoing Senior Managers understand the importance of contributing to a comprehensive handover to their successor. However, when an exit is contentious, things can sometimes run less smoothly. In a small number of cases, we have seen Senior Managers try and use their input into their handovers as a strategic tool to bolster their position in pending or ongoing employment disputes."

Robbie Sinclair – Senior Associate, Allen & Overy

The Duty of Responsibility

Reasonable steps

The concept of 'reasonable steps' for senior management is not a new one. The concept existed under the approved persons regime, albeit not in the form of the Duty of Responsibility.

What may or may not constitute 'reasonable steps' under the SMCR has not yet been publicly tested. However, behind the scenes, firms and their Senior Managers have been giving a lot of thought to what constitutes 'reasonable steps' – both in business as usual situations, as well as when issues arise.

For the most part, Senior Managers have not needed to make wholesale or significant changes to the way in which they operate in light of the Duty of Responsibility. However, many Senior Managers have changed the way in which they have been documenting the reasonable steps that they take. There has been a particular focus on how Senior Managers should document the more informal interactions that they have with colleagues. This includes, for example, 1:1 catch-ups they may have with their direct reports and ad hoc discussions with those direct reports and others.

There is clearly a balance to be struck in this area. In the early days of the SMCR being in force, Senior Managers were asking whether they needed to record each and every interaction that they had. Such an approach is likely to be disproportionate and would also represent a considerable administrative burden on Senior Managers and their firms. As a result, Senior Managers have been using a variety of methods to record material discussions, instructions and interactions that they have outside of formal committees. These include using meeting planners, day books and emails to confirm important points. Senior Managers have also found that educating their direct reports about the obligations of Senior Managers (even if they are not Senior Managers themselves) has helped their direct reports to better support them in discharging their regulatory obligations.

"We have seen a noticeable trend in relation to the style of committee minutes. Although not verbatim transcripts of proceedings, minutes now tend to be much more detailed. As well as recording the topic of discussion and any decisions taken, they also record the discussion, debate and challenge that took place, as well as any dissenting views expressed."

Sarah Hitchins, Senior Associate – Allen & Overy

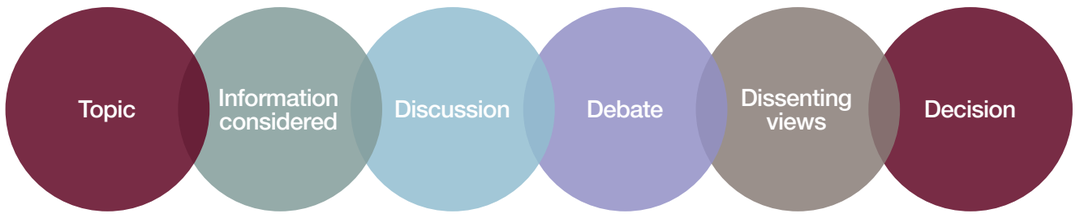
Collective decision making

Many Senior Managers have queried how the concept of individual accountability works in the context of decisions that are taken collectively, for example, by members of a committee.

The FCA has made it clear that the SMCR is not intended to cut across the concepts of collective responsibility or collective decision-making. The FCA accepts that it will be appropriate for some decisions to be taken collectively by a group of individuals. However, in the event that a collective decision is made, the FCA may seek to scrutinise the roles that individual Senior Managers played in that collective decision. The FCA's guidance on reasonable steps states that a Senior Manager must take reasonable steps to ensure that, where they are involved in collective decision-making and it was appropriate for the decision to be taken collectively, they informed themselves of the relevant matters before being taking part in the decision and exercised reasonable care, skill and diligence in contributing to it.

This approach has prompted a number of firms to revisit the way in which their committees operate, ranging from the frequency with which they meet, their terms of reference, the management information that they consider and the way in which minutes are taken. In particular, we have observed a noticeable trend towards minutes becoming much more detailed and recording more than simply what topics were discussed and what decisions were taken. Where appropriate, they now routinely detail discussions, debates and dissenting views expressed by committee members.

More detailed committee minutes documenting material decisions



Escalation

A common question from Senior Managers is how they should manage escalations. This is particularly common among Senior Managers of firms or branches operating in the UK that are headquartered overseas.

We have seen situations where Senior Managers have needed to escalate issues to senior management in their head offices, including to individuals who are not their usual line managers. Common examples include where a Senior Manager has requested additional resource or budget, but has had this request turned down by their local or offshore line managers.

Interactions with regulators

Firms' relationships with the FCA and the PRA have typically been handled by their Compliance, Regulatory Relations or equivalent teams. However, the regulators are now expecting Senior Managers from the business and other controlled functions to play a greater role in their firms' relationships with them. For example, when an issue arises regulators typically expect the Senior Manager(s) with responsibility for the relevant business area(s) and control function(s) to be involved in communicating that issue to them from the point of self-reporting onwards. The regulators are greatly assisted by Statements of Responsibilities and Management Responsibilities Maps when determining which Senior Managers should be involved in these interactions.

"The regulators have provided little guidance for Senior Managers on how they should handle situations where issues are escalated but, in the Senior Manager's view, not adequately dealt with. However, in enforcement Final Notices, the FCA has indicated that in extreme situations, where a senior individual has exhausted all escalation channels in relation to a significant matter, they may find themselves in the difficult position of having to blow the whistle to the FCA and/or the PRA and resign from their role. In practice, the need for this kind of extreme action is likely to be reserved for the rarest of situations."

Calum Burnett, Partner – Allen & Overy

Annual assessments of fitness and propriety

Many firms underestimated the amount of time and resource that would be required to implement and operate the infrastructure that is required in order to undertake annual assessments of fitness and propriety for their Certified Persons.

Some of the larger banks that are subject to the SMCR have several thousand Certified Persons, meaning that managing the process of certifying each and every one of these employees (include those based overseas) can be a significant operational undertaking.

However, the smaller firms with less Certified Persons have still found this process to require significant resources.

The following are the key practical lessons learned from firms' annual assessments of fitness and propriety:

A single annual assessment window:

The FCA and the PRA indicated that firms may wish to incorporate their annual fitness and propriety assessments into their existing annual appraisal processes. Adopting this process means that firms undertake their fitness and propriety assessments during a single window of time each year, as opposed to at different times throughout the year. Although this approach means that firms go through what can be quite an intensive period when all fitness and propriety assessments must be undertaken Persons, many firms have found that this approach is easier to manage in practice. In particular, firms have found this approach makes it easier for them to check that each of their Certified Persons have been issued with a certificate of fitness and propriety.

Operational risk:

There is no requirement for firms to have automated solutions to manage their annual certification processes. Indeed having such a solution may be disproportionate for firms with smaller populations of Certified Persons. However, where firms use manual solutions to manage their annual fitness and propriety assessment processes, they should assess and mitigate the operational risk posed by these solutions. For example, they must take steps to ensure that they have controls in place to ensure that certificates are issued to each Certified Person within the required timeframe and that associated processes, such as self-attestations and line manager feedback, have been completed.

Training:

Firms have spent a significant amount of time providing training to line managers who are responsible for assessing the fitness and propriety of their direct reports. This training has been an important way of ensuring that those line managers understand what fitness and propriety means, and the kinds of behaviours they should be interpreting as potential fitness and propriety issues both during the annual fitness and propriety assessment process and throughout the year. Some line managers have questioned how they can positively prove whether their direct reports have conducted themselves with honesty and integrity. In practice, line managers typically assess this element of fitness and propriety by relying on the absence of any evidence to suggest that one of their direct reports has acted in a way which indicates a lack of honesty and integrity.

Audit trails:

Firms must ensure that they have sufficient audit trails sitting behind decisions that are taken in relation to routine fitness and propriety assessments. A simple 'yes' or tick in a box to confirm a Certified Person's fitness and propriety is unlikely suffice. Firms must ensure that they maintain a robust audit trail of the reasons why each Certified Person has been assessed as being fit and proper, including the information that has been taken into account in order to reach this decision.

Firms will have completed their third annual certification cycles by March 2019. However, there are still a number of challenging issues that firms are continuing to face as part of their annual fitness and propriety assessment cycles.

Some of these issues are more challenging for firms with larger populations of Certified Persons. However, even those firms with small numbers of Certified Persons have encountered issues in practice. For example:

Consistency:

Maintaining consistency of approach can be challenging, especially when a firm has many line managers who may take a variety of different views on what may constitute fitness and propriety. As is noted above, training can play an important role in helping to ensure consistency. However, some firms are reviewing samples of their annual fitness and propriety assessments with a view to identifying inconsistencies in approaches between business areas and individual line managers.

Performance issues:

A number of clients have queried whether general performance issues may mean that a Certified Person is not fit and proper to perform their role. Although performance is a factor that will be relevant to assessing an individual's fitness and propriety, general performance issues do not typically warrant a finding that an individual is not fit and proper. Firms are usually continuing to handle general performance issues through their usual performance improvement plan processes.

Sensitive issues:

Sensitive issues, such as physical and mental health issues, can impact the way in which an employee is able to perform their role. Employers need to handle these issues sensitively, including when it comes to assessing employees' fitness and propriety. Where health issues are impacting an employee at the time of their annual fitness and propriety assessment, firms are considering how they should handle the assessment on a case by case basis with a focus on how they can assist and support the employee in relation to the issues that they are experiencing.

Encouraging employees to self-disclose issues:

Events that happen in an individual's private life can impact their fitness and propriety. However, unless employees proactively disclose such issues, it is likely to be difficult for firms to find out about these issues and take them into account when assessing fitness and propriety. As a result, it is important that firms make it clear to their Senior Managers and Certified Persons that they must report any issues that arise that may impact their fitness and propriety, including issues that arise outside of the workplace. Firms should provide guidance to their employees about the kinds of issues that should be reported and to whom. Firms should handle these issues carefully and confidentially in order to create and embed a culture in which employees feel that they can come forwards with these kinds of issues.

"Firms have effectively been turned into 'mini-regulators' with responsibility for considering regulatory issues when their employees engage in misconduct. As a result, these kinds of issues are not just 'HR issues' – they require input from Legal and Compliance in order to ensure that the relevant regulatory considerations and context are taken into account."

Robbie Sinclair, Senior Associate – Allen & Overy

Managing employee misconduct

One of the key features of the SMCR was that it put responsibility back onto firms for tackling their own employees' misconduct. Firms must proactively consider whether their employees' misconduct may constitute a breach of the FCA/PRA Code of Conduct and, for Senior Managers and Certified Persons, impact their fitness and propriety.

Prior to the SMCR coming into force, many firms underestimated the frequency with which they would have to consider issues such as compliance with the FCA/PRA Code of Conduct and fitness and propriety.

In some cases, assessing and coming to views on these issues has been relatively straightforward. For example, in relation to particularly egregious conduct or where the guidance published by the FCA directly relates to the type of misconduct that an employee has engaged in.

However, even three years into the SMCR there are many 'grey areas' that remain. In some cases, firms have taken different views when it comes to the FCA/PRA Code of Conduct and fitness and propriety in relation to the same or very similar misconduct. These different views are typically reached due to firms having different risk appetites and views on certain types of misconduct.

Firms were required to have the infrastructure needed to assess breaches of the FCA/PRA Code of Conduct and fitness and propriety from day one of the SMCR being in force. A number of firms have changed the way in which they go about assessing these issues alongside their disciplinary and remuneration adjustment processes since March 2016.

"Firms must make it clear to their Senior Managers and Certified Persons that they need to disclose issues that happen both in and outside of the workplace that may impact their fitness and propriety. We have seen many cases where it is the fact that an employee has failed to disclose something that has resulted in a negative fitness and propriety finding being made, as opposed to the underlying issue that they failed to disclose. Employees should be told that if they are in any doubt about whether something needs to be disclosed, they should err on the side of caution and report it to their employer without delay."

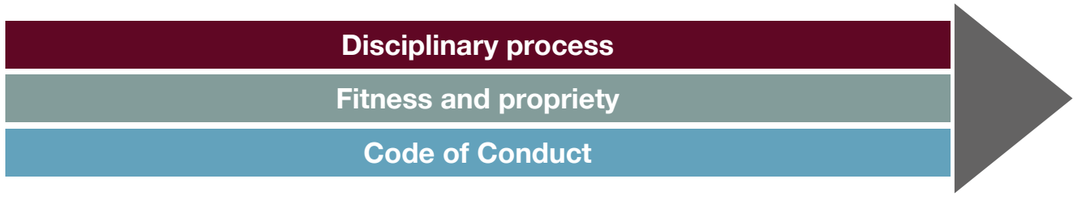
Sarah Hitchins – Senior Associate, Allen & Overy

No 'one size fits all' process

Firms continue to take a variety of approaches to assessing whether employee misconduct has breached the FCA/PRA Code of Conduct and/or impacted the employee's fitness and propriety. There is no 'one size fits all' approach in this area.

When the SMCR was implemented, a number of firms put in place processes for assessing breaches of the FCA/PRA Code of Conduct and fitness and propriety which were separate to their existing disciplinary processes. Other firms opted to take a different approach, and included these processes within their existing disciplinary processes to form a single combined process. Some firms have also introduced oversight panels, which play an advisory role in relation to decisions that are taken in relation to breaches of the FCA/PRA Code of Conduct and fitness and propriety issues.

A single, combined process



Multiple, separate processes

A number of firms have switched between these two approaches over the past three years, based on their experiences of operating them in practice, both of which have their advantages and disadvantages. For example, a single, combined process, may be easier to operate in practice. However, that process places a significant amount of pressure on a disciplinary hearing manager who will be responsible for taking a decision not only in relation to the disciplinary but also in relation to whether there has been a breach of the FCA/PRA Code of Conduct and/or there is a fitness and propriety issue. Things may not necessarily be more straightforward if a firm has multiple, separate processes. In particular, this approach can result in decisions being reached that cannot be reconciled, eg a disciplinary sanction which falls short of dismissal and a finding that an employee is no longer fit and proper.

Common types of issue or misconduct

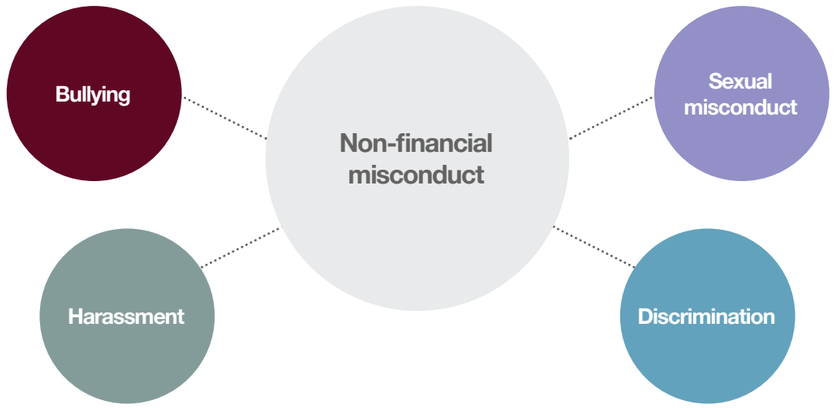
The following types of issue or misconduct have been particularly common within firms over the past few years, alongside a number of issues that have arisen in relation to misconduct concerning financial services activities:

Low value theft within the workplace	Misuse of confidential information	Falsifying documents and forging signatures
Genuine but material mistakes	Failure to adhere to personal account dealing rules	Bullying
Misuse of firm IT systems and equipment	Inflated expense claims	Failure to complete mandatory training
Material breaches of internal policies and procedures	Criminal charges in relation to activities outside the workplace	Failure to escalate issues
Failure to admit to misconduct	Failure to co-operate with internal or external investigations	Intentionally destroying relevant records/evidence

Non-financial misconduct

'[N]on-financial misconduct is misconduct, plain and simple' is the clear message that has been delivered by the FCA.

The FCA includes a variety of conduct under the banner of 'non-financial misconduct', including sexual misconduct, sexual harassment, other forms of harassment, discrimination and bullying. The FCA sees these forms of behavior as contributing to the culture hygiene of firms and having a significant impact on aspects of firms' cultures, such as the extent to which their employees are able to perform their roles in accordance with regulatory requirements and feel able to 'speak up'.



The FCA has made it clear that 'non-financial misconduct' can amount to breaches of the FCA/PRA Code of Conduct and can also impact an individual's fitness and propriety. As a result, firms should not assume that instances of 'non-financial misconduct' are just 'HR issues' and should be treated as such. Instead, firms must give full consideration to the regulatory implications of this kind of misconduct. A number of firms have taken this approach since the SMCR came into force, as part of an initiative to take a more holistic view of the types of issues that may need to be considered under the FCA/PRA Code of Conduct and for the purposes of fitness and propriety. However, the FCA's more recent statements on this topic have left the industry in no doubt about the FCA's stance in relation to 'non-financial misconduct' and that it needs to be considered from a regulatory perspective.

"The financial services industry is not immune from the #metoo movement. Far from it. The FCA has made it clear that sexual harassment and misconduct matters. The FCA's interest in allegations and findings of sexual harassment or other sexual misconduct is part of the its broader focus on culture within the UK financial services industry. We find ourselves being asked with increasing frequency how allegations and findings of sexual harassment or other sexual misconduct may impact firms and individuals from a regulatory perspective."

Sarah Henchoz, Partner – Allen & Overy

Considering direct and indirect responsibility

When more material issues arise, firms typically turn their attention to the individuals who are directly responsible for or implicated in whatever has happened. However, the regulators expect firms to look beyond these individuals and consider the roles played by other individuals who may be indirectly responsible for what has happened. This includes, for example, line managers or supervisors and, in some cases, Senior Managers. Firms should take care to document the thought process that they go through in relation to determining who may have direct or indirect responsibility for an issue and any action that may need to be taken in respect of those individuals.

These broader individual accountability exercises will not be necessary in relation to each and every instance of employee misconduct. However, firms should consider whether this kind of exercise should be undertaken in relation to a particular case.

"Individual accountability exercises cannot just start and stop with those individuals who were directly implicated in or responsible for a matter. Firms must turn their minds to whether any action may need to be taken against other individuals who may have been indirectly involved in or responsible for what happened, including supervisors and, in some cases, all the way up the management chain to Senior Managers."

Calum Burnett, Partner – Allen & Overy

Consistency and trends in relation to employee misconduct

Most firms have built up a portfolio of instances of employee misconduct over the past three years which they have had to consider under the SMCR. Although new examples of misconduct will continue to arise, these portfolios have helped firms to monitor the consistency of their approach to assessing compliance with the FCA/PRA Code of Conduct and fitness and propriety.

Some firms have introduced conduct panels in order to help ensure consistency of approach in relation to these assessments. These panels typically include individuals from HR, Legal and Compliance but may also include individuals from other control functions or the business. The role played by these panels varies from firm to firm. In some firms, these panels provide guidance to disciplinary hearing managers in order to help them understand the regulatory context that applies to the misconduct that they are considering as part of their firm's disciplinary process. In other firms, these panels also play an oversight role and review samples of regulatory decisions that have been taken in relation to employee misconduct in order to check that a consistent approach has been taken and that this approach continues to correspond with regulatory requirements and expectations.

Regardless of whether firms have conduct panels, now is a good time for firms to undertake a review of some or all of the decisions that they have taken in relation to compliance with the Code of Conduct and fitness and propriety. The purpose of this review would be to check that a consistent approach is being taken and that the decisions taken correspond with the latest industry standards and statements made by the FCA and the PRA.

"Consistency is key when it comes to assessing breaches of the Code of Conduct and fitness and propriety. Ensuring consistency of approach in practice can be difficult but this is where conduct panels can play an important role. These panels can help to ensure that the same group of individuals are involved in or at least review assessments in order to check for consistency, as well as any emerging themes and trends in relation to employee misconduct."

Robbie Sinclair, Senior Associate – Allen & Overy

"No discussion about regulatory references is complete without talking about 'Question G' in the FCA's template form. This is by far the most challenging part of a regulatory reference to complete when issues have arisen in relation to an employee. Although firms take different approaches, most firms are tending to take quite a conservative approach and, if they are in any doubt, including information in response to Question G."

Sarah Henchoz, Partner – Allen & Overy

Regulatory references

Requesting and responding to requests for regulatory references have thrown up a number of challenges for firms since March 2017, when the regulators' more prescriptive rules in this area came into force.

Firms have had to introduce new policies and processes for handling the regulators' requirements relating to regulatory references. They have also had to grapple with the challenges associated with providing 'qualified' regulatory references in respect of departing or former employees, taking care to balance regulatory requirements with employment law obligations in this area.

Outsourcing

A number of firms outsource their regulatory reference processes, either to offshore teams within their firms or to third party companies. These arrangements are permitted by the regulators. However, the regulators have made it clear that firms retain overall responsibility for ensuring that they comply with their rules relating to regulatory references.

As a result:

– Firms have reviewed and, where necessary, enhanced their service level or outsourcing agreements with the teams or third parties who manage their regulatory reference processes. These enhancements have been designed to ensure that regulatory requirements in this area are understood and met. They tend to cover not only the basic requirements relating to requesting and receiving regulatory references, but also the steps that must be taken if information is missing from a regulatory reference received.

– Firms require material breaches of their processes to be reported to them without delay. Many firms also require periodic reporting which assesses the performance of their outsourced providers against the service level agreement and key performance indicators agreed. This periodic reporting helps firms to spot any emerging themes or issues in relation to their outsourcing arrangements.

– Firms routinely exercise their audit rights in relation to third party companies that undertake their regulatory reference processes or undertake internal reviews if these processes are handled by other teams. These audits or reviews have been undertaken in order to ensure that the companies or teams with responsibility for regulatory references are complying with firms' regulatory obligations in this area. Audit visits or internal reviews usually include a review of a sample of regulatory references provided and received in order to check that these references and the processes followed in relation to them comply with agreed processes and regulatory requirements.

– Firms have provided very specific guidance that must be followed if a qualified regulatory reference is received from another firm. Typically firms require these references to be escalated to their HR and/or Compliance teams without delay so that they can be considered on a case by case basis.

An area which has not typically been outsourced by firms is the drafting and provision of 'qualified' regulatory references in respect of departing or former employees. Given the delicate balance that needs to be struck between complying with regulatory requirements and employment obligations, firms' Compliance, Legal and HR teams tend to deal with the preparation of qualified regulatory references.

"Drafting 'qualified' regulatory references requires a delicate balance to be struck between regulatory requirements on the one hand and employment law obligations on the other. Achieving this balance can sometimes be challenging, but most firms are getting more used to drafting these documents."

Sarah Hitchins, Senior Associate – Allen & Overy

Qualified regulatory references

Most regulatory references are 'unqualified' in that they do not contain any information about an employee which may call into question their fitness and propriety or compliance with the FCA/PRA Code of Conduct. However, regulatory references that need to be 'qualified' and do contain this kind of information about an employee can prove more challenging for firms to prepare.

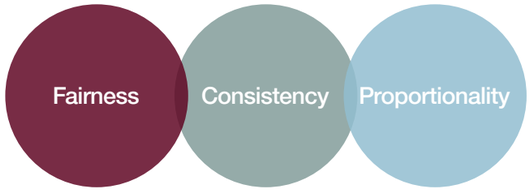
– **Factual:** Questions E, F and G in the FCA's regulatory reference template require firms to include explanatory information in relation to breaches of the FCA/PRA Code of Conduct or fitness and propriety issues. Where this information needs to be included, firms usually keep it factual and limited to the information that they have been able to verify. Where it has not been possible to complete a full investigation or disciplinary process, firms typically state this in a qualified regulatory reference.

– **The opportunity to comment:** Firms are not obliged to provide employees with the specific wording that they propose to include in a qualified regulatory reference about them. However, most firms at least put the information that they are intending to refer to in the regulatory reference to the employee so that they can comment on the substance of the findings or the allegations that will be referred to in it. Although firms are not obliged to alter the wording based on any feedback received, firms typically state in the regulatory reference if, for example, the employee denies the allegations or findings about them which are going to be included in their regulatory reference.

– **Level of detail:** Deciding how much detail to include in a regulatory reference can be challenging, especially if the issue or misconduct that needs to be disclosed in a regulatory reference is particularly sensitive or confidential.

– **Negotiation:** In light of the regulators' prescriptive rules relating to providing and updating regulatory references, employers are not in a position to 'negotiate' the contents of regulatory references with departing or former employees. Claimant lawyers may still request copies of regulatory references and seek to negotiate their contents. However, firms cannot fetter their ability to comply with their regulatory obligations in this area.

The Banking Standards Board is currently consulting on new guidance in relation to regulatory references. Three principles sit at the heart of this proposed guidance:



The Banking Standards Board's proposed guidance covers issues that include:

– **A second opportunity to comment:** Whether employees should be given a second opportunity to comment on allegations or findings made about them if, for example, they did not originally comment on them or they did not know that these allegations or findings would be included in a regulatory reference. The proposed guidance makes it clear that, if such a second chance is given, it should not be construed as a re-opening of any investigation or disciplinary process. Instead this process would just be part of the process followed by firms in order to prepare qualified regulatory references.

– **Awareness:** Making sure that employees realise that their firm may be required to provide a regulatory reference in respect of them when they leave the firm, regardless of whether any regulatory reference provided is likely to be qualified. Many firms already include this information in their employee handbooks and in disciplinary outcome letters.

– **Incomplete investigation or disciplinary processes:** Firms sometimes face a situation whereby an employee resigns before an investigation or disciplinary process can be completed. The FCA's guidance on regulatory references states that firms are not required to disclose this information in a regulatory reference, but notes that they may wish to do so. The Banking Standards Board is proposing to advise firms that, if there is evidence of wrongdoing in relation to an employee that would have been pursued through further investigation or disciplinary proceedings, they should include that information in a regulatory reference. If firms follow this approach, they should state in the regulatory reference that it was unable to complete its investigation or disciplinary process.

– **Consistency:** The Banking Standards Board has stated that firms should consider undertaking a periodic review of regulatory references that they have provided. The purpose of this periodic review would be for firms to assess whether they are taking a consistent approach to providing regulatory references. Questions that the Banking Standards Board has said that firms should be asking themselves include: *'Are we reporting relevant factors consistently to enable receiving firms to use regulatory references fairly in their approach to recruitment?'* and *'Are we being fair and consistent with individuals in seeking and taking account their views?'*

– **Not using regulatory references as a 'binary screening tool':** The Banking Standards Board urges firms not to use regulatory references as a *'binary screening tool'*. It states that firms that have a '*blanket rejection policy for regulatory references containing details of complete or incomplete disciplinary processes, or unverified information about poor conduct, will not be fair to the individual*'. The proposed guidance states that, in order to ensure fairness, firms should ask a prospective employee during the recruitment process about issues already or likely to be disclosed in their regulatory reference.

Updating regulatory references

Firms are obliged to update a regulatory reference that they provided in the event that information comes to light that would have changed the contents of the regulatory reference. Updated regulatory references are relatively uncommon, but circumstances in which they may be required include:

– If a new allegation of misconduct comes to light.

– If an allegation of misconduct was not pursued previously but new information has come to light that would have changed this decision.

– If a disciplinary appeal was outstanding when the original regulatory reference was given.

Firms should ensure that its employees are aware of the requirement to update regulatory references. This will help ensure that information that comes to light after an employee leaves is escalated to the relevant team so that they can consider if a regulatory reference that has been given needs to be updated. In particular, individuals who work in Legal, Compliance and HR should be familiar with the requirement to update regulatory references, as they will typically be involved in running the investigations which may give rise to this requirement.

Even though updated regulatory references are not common, providing an updated regulatory reference which is fair, consistent and proportionate can present many challenges. The Banking Standards Board has proposed that firms should attempt to contact former employees using more than one method if they are proposing to update their regulatory reference in order to provide them with an opportunity to comment on its contents. The Banking Standards Board has also stated that former employees should be given a *'reasonable timeframe within which to respond'* and recommends that this timeframe is at least 15 business days, with a prompt being sent before this timeframe expires if a former employee has not responded.

"When updating regulatory references, some firms have struggled to work out if a former employee is still employed by the firm that the original regulatory reference was given to. The introduction of the Directory will help firms with this task and will save them having to approach other firms to confirm this information."

Robbie Sinclair, Senior Associate – Allen & Overy

Enforcement appetite

The FCA has reiterated its commitment to individual accountability and, in particular, taking enforcement action against individuals when their conduct falls short of regulatory standards. In the context of enforcement investigations into firms, individuals are no longer treated as an 'afterthought' and in some cases individuals (including Senior Managers and Certified Persons) will be investigated alongside their firm. The FCA has confirmed:

We carry out investigations into both firms and individuals together where it appears those individuals may be involved in the suspected breach. Usually these investigations will be carried out at the same time. This allows relevant facts and matters to be considered together, in the round. This is especially important where relevant individuals have had a senior management or governance role in the circumstances under investigation.[1]

However, the FCA's approach to investigating Senior Managers, Certified Persons and individuals who are only subject to the FCA's Code of Conduct has been modest[2]:

These numbers are likely to increase as the FCA identifies more misconduct that has occurred since March 2016. We also anticipate seeing a sharper increase in these figures after 9 December 2019 as the number of individuals who are subject to the SMCR will increase significantly once the SMCR is extended to cover all FCA-only authorised firms.

[1] Source: FCA Mission: Our Approach to Enforcement (March 2018)
[2] Source: Freedom of Information Act request submitted to the FCA by Allen & Overy.

"The SMCR has not turned out to be the enforcement tool that many thought it would be. Although the FCA takes its focus on individual accountability very seriously, it has taken a modest approach to opening enforcement investigations into Senior Managers, with only 17 such investigations being opened in the first three years of the SMCR being in force. However, we can expect this number to increase."

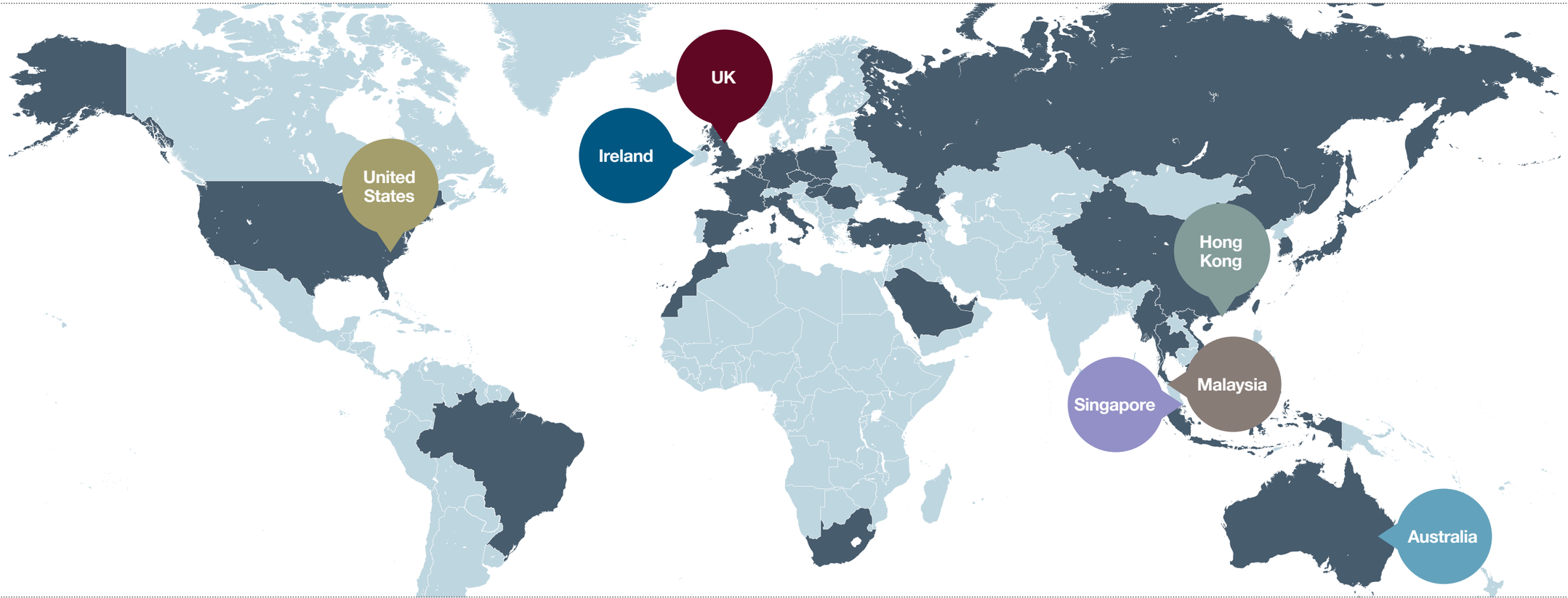
Calum Burnett, Partner – Allen & Overy

Individual accountability regimes around the world

United States

The Yates Memo and Federal Reserve Board Rating System

No formal individual accountability regime, but the Yates Memo on '*Individual Accountability for Corporate Wrongdoing*' was published in 2015 and revised in November 2018. In November 2018, the Federal Reserve Board adopted a new rating system for large financial institutions, which includes supervisory expectations for senior management, business line management, and independent risk management.



UK

The Senior Managers and Certification Regime

In force since March 2016 for banks, building societies and a small number of investment firms. Due to be extended to cover all other financial services firms (including asset and fund managers, private equity firms and broker-dealers) in December 2019.

Hong Kong

The Manager-in-Charge Regime and the Management Accountability Initiative

In force since April 2017 with staggered roll-out of obligations (the Manager-in-Charge Regime) and in force since March 2018 (the Management Accountability Initiative).

Australia

The Banking Executives Accountability Regime

In force for large authorised deposit-taking institutions since 1 July 2018. In force for small to medium authorised deposit-taking institutions from 1 July 2019. Proposals have been announced to extend the regime to all other financial services firms (date TBC).

Singapore

Proposed Guidelines on Individual Accountability and Conduct

Consultation issued in April 2018. Implementation date yet to be confirmed.

Ireland

Proposed Senior Executive Accountability Regime and other measures

Proposals announced in July 2018. Implementation date yet to be confirmed.

Malaysia

Proposed Responsibility Mapping

Discussion Paper published in February 2018. Implementation date yet to be confirmed.

Our Global Individual Accountability Working Group

Our lawyers around the world have been closely following regulatory developments relating to individual accountability since the financial crisis.

We have advised in excess of 35 international banks on the full range of implementation and post-implementation issues relating to the SMCR. We are also advising a significant number of asset and fund managers, private equity firms and broker-dealers in relation to the extension of the SMCR.

Outside the UK, our lawyers have advised a variety of financial services firms in relation to individual accountability regimes in other jurisdictions (including Australia, Hong Kong and Singapore) and issues arising from them. Our cross-border experience in this area helps to ensure that our clients benefit from the lessons learned by our lawyers and clients in those jurisdictions in relation to their individual accountability regimes.

If you have any questions about our work in relation to individual accountability regimes, and the support that we can provide to clients in this area, please do not hesitate to contact one of the members of our Global Individual Accountability Working Group listed below.

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Allen & Overy has launched a new regulatory consulting group. Headed by Sally Dewar, A&O Consulting focuses on providing regulatory business advice which is delivered as an integrated part of the regulatory legal services that we already provide to our financial services clients across the world.

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