FINANCIAL SERVICES BRIEFING

Senior managers and certification regime: another year on

The Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) senior managers and certification regime (the regime) has been in place for just over two years. During this period, firms have experienced a range of challenges in relation to the regime, with some firms revisiting their approaches to various aspects of the regime.

Since the regime first came into force, most firms have had to use the processes and procedures that they implemented for the purposes of the regime (*see Briefing "Senior managers and certification regime: the first year", www.practicallaw.com/1-639-3048*).

These range from processes and procedures relating to managing conduct and performance issues, regulatory references, handovers between senior managers and more general governance considerations. Some firms have already decided to revisit and amend their processes based on these experiences. Although neither the FCA nor the PRA has yet taken enforcement action against an individual under the regime, the FCA has several investigations underway (*see "Enforcement" below*).

Examples of challenging conduct issues

In some instances, firms will feel comfortable assessing whether an employee's conduct amounts to a breach of the Financial Conduct Authority's (FCA) Code of Conduct or calls into question the employee's fitness and propriety. However, firms are facing situations where these assessments are not straightforward, for example, if an employee has:

- Made a genuine mistake but has proactively owned up to making the mistake and co-operated in a subsequent investigation and remediation exercise.
- Been found to have committed sexual harassment in the workplace or at work-related events.
- Misused company IT equipment in a way that does not necessarily have a negative impact on the employee's work.
- Sent confidential information to a personal email address for non-malicious reasons, for example, so that the employee can work on that information from home.
- Bought and used illegal substances outside the workplace.

Firms have also had to handle other employee issues in light of the FCA and Prudential Regulatory Authority senior managers and certification regime, including those relating to mental health issues, such as stress and depression, which may affect an employee's ability to continue to be assessed as fit and proper to perform the role. Firms have generally handled these issues sensitively, with the focus being on helping those employees through occupational health support, even if it means that those employees temporarily cannot perform roles that require them to be certified or approved as senior managers while they receive this assistance and until they sufficiently recover from the mental health issue.

Conduct and performance

Firms have continued to act as mini-regulators with responsibility for assessing the fitness and propriety of employees falling within the regime on an ad hoc basis when issues arise, in addition to their routine annual assessments of fitness and propriety. In these situations, firms have also had to decide if an employee's conduct breaches the FCA's Code of Conduct (the Code) which, since 7 March 2017, has applied to almost all individuals working for firms.

Grey areas. Firms have continued to face challenges when assessing fitness and propriety and breaches of the Code in certain circumstances. These more challenging circumstances include when employee misconduct is caused by a genuine mistake or is otherwise unintentional (*see box "Examples of challenging conduct issues"*). Firms have to tread a fine line in these cases. Although firms recognise that they must hold individuals to account for misconduct, in accordance with the letter and spirit of the regime, firms are also cautious about being seen to treat this kind of misconduct too severely. In particular, firms do not wish to discourage employees from raising issues and owning up to any mistakes that they have made by punishing them too harshly.

As firms undertake more assessments of fitness and propriety and breaches of the Code, they are building up portfolios of past cases. These cases can be used internally in order to help firms to handle future cases and ensure consistency between cases, which is important from an employment perspective. The processes adopted by firms have tended to involve both HR and compliance teams, which has further assisted with ensuring consistency within firms.

Employment tribunals. The regime is beginning to enter the world of employment litigation, for example:

- A tribunal might be asked to decide on the lawfulness of an employer's position on dismissal, reinstatement or re-engagement, where the employer argues that it could not continue to employ an individual not judged to be fit and proper.
- An employee might claim additional damages in light of the effect of an impaired regulatory reference (*see below*).

As it will take some time for tribunals to catch up on the regime, it is important for employers to follow a robust process which is compliant with employment law when considering fitness and propriety and breaches of the Code (*see box "Assessing breaches of the Code" and feature article "Regulators and disciplinary action: striking a balance", www.practicallaw.com/6-640-8896*).

Regulatory references

The new regulatory references rules have

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now been in force for just over a year (*see News brief "Regulatory references: haunted by the past", www.practicallaw.com/8-634-8873*). Firms spent a lot of time implementing policies and procedures to ensure that they comply with these rules.

Outsourcing. A number of firms outsource some or all of their regulatory references processes. Where this is the case, firms should regularly check how their outsourced providers are performing these processes on their behalf. For example, firms should make sure that any impaired references received by their outsourced providers on their behalf are escalated and fed into their recruitment processes.

Impaired references. As expected, firms have thought long and hard about the relatively small number of impaired references that they have provided in respect of outgoing or former employees over the past year. In particular, firms have been mindful of the impact that an impaired reference is likely to have on an employee's future employment prospects, especially within the financial services industry. Firms are also paying close attention to the content of individuals' pre-employment vetting information, such as attestations confirming that an individual has not been the subject of an investigation or disciplinary process at their former employer, and comparing that with the contents of impaired regulatory references. In some instances, issues have come to light through impaired regulatory references which individuals had not disclosed in their pre-employment vetting.

Negotiated exits. A key point in relation to negotiated exits has been whether firms should agree the wording of a draft regulatory reference in a settlement agreement, subject to the usual carve outs that allow a firm to change the draft reference if new information comes to light. The overriding response from employers has been not to agree to this type of wording in light of the regulatory reference rules.

Claims. Regulatory references provide new employers with more information on candidates and, crucially, information that could harm the candidate's prospects of finding a new role. Firms have therefore been concerned about the prospect of litigation in this area, particularly from former employees, for example, for negligent representation or breach of contract. In practice, firms have mitigated the risk of these claims by only creating an impaired reference following due process and using careful and objective wording when drafting any impaired reference.

Assessing breaches of the Code

Even if the Financial Conduct Authority and the Prudential Regulation Authority do not intend to take enforcement action against an individual, there is an expectation that firms will undertake their own assessments as to whether an employee has breached the FCA's Code of Conduct (the Code). Most firms undertake these assessments as part of their disciplinary processes, whereas others have opted to consider the matter as part of a separate process that usually runs alongside any disciplinary process.

It is expected that assessments as to whether employees have breached the Code will not only consider employees who are directly implicated in a matter, but also those who are indirectly responsible for it, for example, by virtue of their supervisory or oversight responsibilities. In many cases, this will require firms to consider whether senior managers with responsibility for relevant business areas have breached one or more of the senior manager conduct rules set out in the Code.

Assessing breaches of the senior manager conduct rules set out in the Code can be difficult for various reasons. Three of the four senior manager conduct rules centre on the concept of "reasonable steps", which can be difficult to assess in practice. In addition, some firms may be reluctant to find that their most senior employees have breached the Code, especially if those senior employees look likely to continue working at the firm.

Enforcement

Neither the FCA nor the PRA has yet reached a public enforcement outcome in relation to a senior manager or a certified person. However, as of late 2017, the FCA had four live enforcement investigations into senior managers and seven into certified persons. This level of investigations into senior managers and certified persons is relatively modest. It is likely that the FCA is treading carefully in terms of the number of enforcement investigations that it is opening into individuals. These investigations tend to be quite resource-intensive for the FCA, not least because individuals are more likely to challenge a decision by the FCA to take enforcement action against them before the FCA's Regulatory Decisions Committee and the Upper Tribunal. In addition, the FCA is no doubt conscious that the industry will be watching carefully to see what enforcement cases it decides to bring under the regime. The FCA will want to achieve outcomes in these cases that reinforce its message around individual accountability.

Extension of the regime

In 2019, the regime is due to be extended to cover all financial institutions in the UK, which amounts to approximately 54,000 additional firms (*www.practicallaw.com/w-010-0340*).

The FCA is yet to finalise its rules for extending the regime, but for the most part they look likely to be similar to the rules that apply to banks, building societies and PRA investment firms. For example, the FCA is proposing to carry across its rules relating to fitness and propriety assessments and regulatory references, as well as the Code. By the time the regime is extended, it will have been in place for at least three years. Firms that will be subject to the regime from 2019 onwards will have the benefit of having seen the challenges faced by other firms, as well as how those firms have addressed these challenges in practice.

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