

## The new Senior Managers Regime, Certification Regime and Conduct Rules in the UK: The Sharpening of the “Sword of Damocles”?

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**Abstract:** The “Sword of Damocles” is the ancient Greek allegorical tale of the imminent and ever-present peril faced by those in positions of great wealth and power. This article provides an overview of the new Senior Managers Regime, the Certification Regime and the Conduct Rules. It explains how the new regimes seek to sharpen the sword of the current Approved Persons Regime and considers whether they are likely to be effective in strengthening individual accountability and improving culture and governance in the UK banking sector.

### Introduction

In their Consultation Paper “Strengthening accountability in banking”, published in July 2015<sup>1</sup> (the “Consultation Paper”), the Financial Conduct Authority (FCA) confirms rules for a new accountability framework for individuals working in banks, building societies and credit unions. In addition to ensuring that senior managers are held accountable in the future for any misconduct that falls within their area of responsibility, the new framework aims to hold individuals *working at all levels* in banks and other relevant firms to appropriate standards of conduct.

The Prudential Regulation Authority (PRA) has simultaneously issued a Policy Statement, which contains some of its final rules on accountability.<sup>2</sup> Both the FCA and the PRA have therefore provided combined final rules for the new accountability framework.

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<sup>1</sup> CP15/22 Strengthening accountability in banking: Final rules (including feedback on CP14/31 and CP15/5) and consultation on extending the Certification Regime to wholesale market activities, July 2015

<sup>2</sup> Policy Statement | PS16/15 Strengthening individual accountability in banking: responses to CP14/14, CP28/14 and CP7/15 dated July 2015  
(<http://www.bankofengland.co.uk/pr/Documents/publications/ps/2015/ps1615.pdf>)

In addition to setting down final rules, the FCA is also consulting on amending rules in regard to the certification of individuals (the “Certification Regime”) involved in wholesale activity, for example trading.<sup>3</sup> Those proposals are set out in Chapter 6 of the Consultation Paper which apply to both UK relevant firms and incoming branches of overseas relevant firms. In particular, the FCA is consulting on amending the regime to ensure individuals who could pose significant harm to the firm or its customers are subject to the Certification Regime.<sup>4</sup> In addition, removing the territorial limitation for material risk takers in both the Certification Regime and Conduct Rules.

## Background

The Senior Manager’s Regime (SMR) and Certification Regime (together “the regimes”) are recent bodies of regulation, born from the UK Parliamentary Commission on Banking Standards (PCBS) recommendations. The PCBS was appointed by both Houses of Parliament in 2012 to consider and report on professional standards and culture of the UK banking sector following the LIBOR and foreign exchange benchmarks manipulation scandals.

In their report entitled “Changing Banking for Good” published in June 2013, one of the PCBS’s key criticisms pointed to a banking culture which gave rise to a lack of accountability of the senior management. In their report, the PCBS concluded that the current Approved Persons Regime (APER) “*fails to perform any of its varied roles to the necessary standard*”. The scope of the APER is “*woefully narrow*” and it does not ensure that individual responsibilities are adequately defined which restricts the regulators’ ability to take enforcement action. Hence, the PCBS proposed the new regimes as part of a broader initiative to improve the culture, governance and accountability within banks and other relevant firms.

The legislative framework underpinning the regimes is provided in the Financial Services (Banking Reform) Act 2013, which sets out amendments to the Financial Services and Markets Act (FSMA) 2000. The SMR and

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<sup>3</sup> In their consultation paper, CP15/22 “Strengthening accountability in banking”, the FCA says, it is important that those responsible for the deployment of trading algorithms are “fit and proper”, to ensure that the algorithms are adequately tested through comprehensive testing to assess their potential behaviour, in particular to ensure they are resilient, do not contribute to disorderly markets or breach market abuse or trading venue rules. The use of trading technology has evolved significantly in the past decade and is now extensively used by market participants. Many market participants now make use of algorithmic trading where a computer algorithm automatically determines aspects of an order with minimal or no human intervention. (<https://www.fca.org.uk/static/documents/consultation-papers/cp15-22.pdf>)

<sup>4</sup> The FCA propose to include individuals responsible for deploying trading algorithms as a further category of significant harm function to capture this activity within the Certification Regime, in light of the extensive use of algorithms in the UK market.

Certification Regime will come into force on 7 March 2016 (the “commencement”).

As provided above, the new regimes are only one aspect of the changes being introduced following the PCBS Report. For example, the FCA and PRA have issued policy statements on remuneration, and the FCA have made changes to the Remuneration Code to improve the alignment between risk and reward in banks’ remuneration arrangements. The FCA and PRA have also developed a package of measures to formalise firms’ procedures for whistleblowing which will allow employees to raise concerns confidentially. Final rules will be issued later in the year. The FCA has issued a number of other papers addressing the subject of accountability in other areas. For example, in its final report, the Fair and Effective Markets Review made proposals for legislative change to enable the extension of the SMR and the Certification Regime to areas of the fixed income, commodity and currency markets. In addition, following support by the PCBS and endorsement from HM Treasury and the Bank of England, the Banking Standards Board (BSB) has recently been established to promote higher standards in behaviour and competence in the banking sector.

### **The Consultation Paper**

The Consultation Paper, which forms the FCA’s policy statement, seeks to offer practical assistance in a number of areas to help firms prepare for the new regimes. It also includes commentary on the allocation of responsibilities that will be needed in practice, as well as an example of a responsibilities map for a credit union and frequency of reporting requirements. The paper reassures firms they can and should adopt a proportionate approach. For example, firms need to be satisfied that a person is *fit and proper* to perform a particular certification function, reflecting the skill set involved. In other words, one size does not fit all.

### **Senior Managers Regime**

#### *Introduction*

The regime focuses on individuals who hold key roles or have overall responsibility for whole areas of relevant firms. Preparations for the new regime will involve allocating and mapping out responsibilities and preparing *Statements of Responsibilities* for individuals carrying out *Senior Management Functions*. While regulators will approve individuals who fall under this regime, firms will also be legally obliged to ensure they have procedures in place to assess their fitness and propriety before applying for approval and at least annually afterwards.

### *Allocation of responsibilities*

Firms are required to allocate responsibilities under the new Senior Managers Regime clearly and without gaps. In doing so, they will need to ensure they understand and carefully consider the following concepts: (i) Senior Management Functions, (ii) Prescribed Responsibilities and (iii) Overall Responsibility

#### *(i) Senior Management Functions*

The FCA and PRA have specified 17 Senior Management Functions (SMF) in total between them. Those are set out in Table A below.<sup>5</sup>

*Table A*

<b>SMF</b>	<b>Description</b>	<b>FCA function</b>	<b>PRA function</b>
SMF1	Chief Executive function		√
SMF2	Chief Finance function		√
SMF3	Executive Director function	√	
SMF4	Chief Risk function		√
SMF5	Head of Internal Audit function		√
SMF6	Head of Key Business Area function		√
SMF7	Group Entity Senior Manager function		√
SMF8	Credit Union SMF (small Credit Unions only)		√
SMF9 <sup>6</sup>	Chairman function		√
SMF10	Chair of the Risk Committee function		√
SMF11	Chair of the Audit Committee function		√
SMF12	Chair of the Remuneration Committee function		√
SMF13	Chair of the Nominations Committee function	√	
SMF14 <sup>7</sup>	Senior Independent Director function		√
SMF16	Compliance Oversight function		√
SMF17	Money Laundering Reporting function	√	
SME18	Other Overall Responsibility function	√	

<sup>5</sup> This table has been extracted from Annex 3 of the Consultation Paper.

<sup>6</sup> The table is shaded to show SMF9-14 are to be held by approved non-executive directors, rather than executives.

<sup>7</sup> In February 2015, the FCA and the PRA published feedback in CP15/544 confirming that the only non executive directors (NEDs) that would require pre-approval as senior managers by the PRA or FCA would be the Chairman, Senior Independent Director and the Chairs of the Risk, Audit, Remuneration and Nomination Committees. Other NEDs would not be included in the regime. In line with this decision, SMF15, the previous Non-Executive Director function, has been removed from all relevant Handbook text and forms. There is no longer a SMF15 function.

Firms will need to ensure that staff holding these SMFs are pre-approved by the regulators. Some of the functions will exist in many larger and smaller firms, such as SMF1 Chief Executive, while others will only be relevant for some firms. For example, SMF13 Chairman of the Nomination Committee function will only be used where a firm has a committee that performs this, or a similar, function.

In its Policy Statement, published in March 2015, the PRA explained its Prescribed Responsibilities may be divided up into different groups which can be extended to cover the FCA's responsibilities too:

1. Prescribed responsibilities that **apply to all firms**. These relate directly to the new SMR and Certification Regimes, for example, responsibility for compliance with regulatory requirements about the responsibilities map.
2. Prescribed responsibilities that apply to **smaller firms only**. The following four broad responsibilities apply to firms that have assets of £250 million or less: (1) risk management; (2) systems and controls; (3) financial resources; and (4) legal and regulatory obligations.
3. Prescribed responsibilities that apply to **larger firms only**. These cover many of the same areas as those applying to smaller firms, but in more detail, for example, there are specific responsibilities relating to recovery and resolution and to culture.
4. Prescribed responsibilities that only apply to **specific types of firms**. For example, if a firm carries out proprietary trading, it will need to allocate responsibility for the firm's proprietary trading activities. These also include client assets sourcebook (CASS) responsibilities.

The combined list of FCA and PRA Prescribed Responsibilities and relevant amended FCA and PRA Handbook rules, are provided in Table B below.<sup>8 9</sup>

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<sup>8</sup> This table has been extracted from Annex 4 of the Consultation Paper

<sup>9</sup> The shaded rows represent Prescribed Responsibilities held by approved NEDs, rather than executives.

Table B

Description of prescribed senior management responsibility		FCA prescribed?	PRA prescribed?
<i>Applying to all firms</i>			
a.	Responsibility for the firm's performance of its obligations under the senior management regime	SYSC 4.7.7R(1)	4.1(1)
b.	Responsibility for the firm's performance of its obligations under the employee certification regime	SYSC 4.7.7R(2)	4.1(2)
c.	Responsibility for compliance with the requirements of the regulatory system about the management responsibilities map	SYSC 4.7.7R(3)	4.1(3)
d.	Overall responsibility for the firm's policies and procedures for countering the risk that the firm might be used to further financial crime	SYSC 4.7.7R(4)	-
e.	Responsibility for the allocation of all prescribed responsibilities in accordance with 3.1	-	4.1(20)
<i>Applying to larger firms</i>			
f.	Responsibility for: (a) leading the development of; and (b) monitoring the effective implementation of; policies and procedures for the induction, training and professional development of all members of the firm's governing body.	SYSC 4.7.7R(5)	4.1(13)
g.	Responsibility for monitoring the effective implementation of policies and procedures for the induction, training and professional development of all persons performing designated SMFs on behalf of the firm other than members of the governing body.	SYSC 4.7.7R(6)	4.1(5)
h.	Responsibility for overseeing the adoption of the firm's culture in the day-to-day management of the firm.	-	4.1(5)
i.	Responsibility for leading the development of the firm's culture by the governing body as a whole.	-	4.1(14)
j.	Responsibility for: (a) safeguarding the independence of; and (b) oversight of the performance of; the internal audit function, in accordance with SYSC 6.2 (Internal Audit)	SYSC 4.7.7R(7)	4.1(15)
k.	Responsibility for: (a) safeguarding the independence of; and (b) oversight of the performance of; the compliance function in accordance with SYSC 6.1(Compliance).	SYSC 4.7.7R(8)	4.1(16)
l.	Responsibility for: (a) safeguarding the independence of; and (b) oversight of the performance of; the risk function, in accordance with SYSC 7.1.21R and SYSC 7.1.22R (Risk control).	SYSC 4.7.7R(9)	4.1(17)
m.	Responsibility for overseeing the development of, and implementation of, the firm's remuneration policies and practices in accordance with SYSC	SYSC 4.7.7R(10)	4.1(18)

	19D (Remuneration Code)		
n.	Responsibility for the independence, autonomy and effectiveness of the firm's policies and procedures on whistleblowing, including the procedures for protection of staff who raise concerns from detrimental treatment	-	4.1(19)
o.	Management of the allocation and maintenance of capital, funding and liquidity	-	4.1(7)
p.	The firm's treasury management functions	-	4.1(8)
q.	The production and integrity of the firm's financial information and its regulatory reporting in respect of its regulated activities	-	4.1(9)
r.	The firm's recovery plan and resolution pack and overseeing the internal processes regarding their governance	-	4.1(10)
s.	Responsibility for managing the firm's internal stress-tests and ensuring the accuracy and timeliness of information provided to the PRA and other regulatory bodies for the purposes of stress-testing	-	4.1(11)
t.	Responsibility for the development and maintenance of the firm's business model by the governing body	-	4.1(12)
u.	Responsibility for the firm's performance of its obligations under Fitness and Propriety in respect of its notified non-executive directors	-	4.1(4)
<i>Applying in specified circumstances</i>			
v.	If the firm carries out proprietary trading, responsibility for the firm's proprietary trading activities	-	4.2(1)
w.	If the firm does not have an individual performing the Chief Risk function, overseeing and demonstrating that the risk management policies and procedures which the firm has adopted in accordance with SYSC 7.1.2 R to SYSC 7.1.5 R satisfy the requirements of those rules and are consistently effective in accordance with SYSC 4.1.1R.		4.2(1)
x.	If the firm outsources its internal audit function taking reasonable steps to ensure that every person involved in the performance of the service is independent from the persons who perform external audit, including (a) Supervision and management of the work of outsourced internal auditors and (b) Management of potential conflicts of interest between the provision of external audit and internal audit services		4.2(3)
y.	If the firm is a ring-fenced body, responsibility for ensuring that those aspects of the firm's affairs for which a person is responsible for managing are in compliance with the ring-fencing requirements		4.2(4)
z.	Overall responsibility for the firm's compliance	SYSC4.7.7R(11)	-

	with CASS		
<i>Applying to small firms only</i>			
aa.	Responsibility for implementing and management of the firm's risk management policies and procedures		5.2(3)
bb.	Responsibility for managing the systems and controls of the firm	-	5.2(4)
cc.	Responsibility for managing the firm's financial resources	-	5.2(5)
dd.	Responsibility for ensuring the governing body is informed of its legal and regulatory obligations	-	5.2(6)

### *Overall Responsibility*

Those individuals who have overall responsibility for activities, functions or areas of the business need to be pre-approved for SMFs. A person with overall responsibility is a someone who has: (1) ultimate responsibility (under the governing body) for managing or supervising that function; and (2) primary and direct responsibility for: (a) briefing and reporting to the governing body about that function; and (b) putting matters for decision about that function to the governing body.<sup>10</sup>

In some cases, the senior manager who has overall responsibility for an activity, function or area will already have been identified as performing a specific SMF, but it is of paramount importance that firms also identify any other individuals who have overall responsibility for an activity, function or area. Where an individual who has overall responsibility for an activity, function or area is not otherwise included in the list of SMFs, that person would need to be pre-approved for SMF18 'Other Overall Responsibility function'.

Firms are expected to satisfy themselves that they have complete lists of their activities, areas or functions, reflecting the business that they conduct. In their Consultation Paper, the FCA provides an indicative list of a firm's main business activities and functions to help firms prepare their responsibilities maps. However, this is not a complete list of areas of responsibility. Equally, the list does not legislate how firms should allocate responsibilities amongst senior management. For example, in one firm an individual might have overall responsibility for 'retail sales', while another firm might organise its business with separate areas of responsibility for retail lending and retail deposits, meaning that it would make sense to assign overall responsibility for these different areas separately. In any event, firms will be expected to clearly distinguish responsibilities.

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<sup>10</sup> SYSC 4.7.11G (Meaning of overall responsibility)



### *Applying the regime to smaller firms*

#### *Senior Management Functions*

The FCA and PRA each require credit unions to approve a minimum of only one senior manager SMF7, who performs functions akin to those of a Chief Executive Officer (CEO) or Executive Chairman. Other smaller firms caught by the regime, such as small building societies, will be required as minimum to have a CEO, a Chief Finance Officer (CFO) and a Chairman. In addition, SMF16 Compliance oversight and the FCA's SMF17 money laundering reporting will also apply. The remaining SMFs set out in the FCA rules will only apply to credit unions if they have other senior manager posts that are subject to the regime (for example, if they were to have executive directors), meaning that in practice they should put forward individuals for approval in line with their size and governance arrangements.

#### *Prescribed responsibilities*

Smaller firms i.e. those with gross total assets of £250 million or less, will be required to allocate eight Prescribed Responsibilities to their senior managers. Those are the four generic responsibilities that apply to all firms, and four high-level responsibilities introduced by the PRA specifically for smaller firms, as set out in *Table B* above. In addition to the eight Prescribed Responsibilities, smaller firms will have to allocate one further Prescribed Responsibility under the FCA rules in regard to financial crime.<sup>11</sup> Other Prescribed Responsibilities may be relevant depending on the business conducted by the small firm. For example, the FCA's prescribed responsibility for a firm's compliance with CASS would also need to be allocated where a firm is subject to CASS. Further Prescribed Responsibilities do not apply to credit unions and small firms. For example, internal audit, risk and remuneration responsibilities which only apply to firms in accordance with the Capital Requirements Directive. In addition, responsibilities relating to induction, training and professional development of senior management and members of the firm's governing body.

In addition to allocating the required and relevant prescribed responsibilities, small firms must ensure that at all times, one or more of its approved senior managers has overall responsibility for each of the activities, business areas and management functions of the firm.

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<sup>11</sup> The FCA will confirm, when making their final rules on whistleblowing, whether or not small firms need to allocate this responsibility

*Sharing responsibilities between individuals*

The FCA and PRA would not expect a firm to normally split an FCA prescribed responsibility between several senior managers, with each only having responsibility for part, or for them to be allocated to two or more senior managers jointly. However, the FCA accepts sharing of responsibility may be justified in some limited circumstances, where this is done as part of a job share or where departing and incoming senior managers work together temporarily as part of a handover exercise. If a firm contravened a relevant requirement in an area where a responsibility is shared, both the PRA and the FCA would consider all SMF managers sharing the responsibility to be jointly responsible.

*PRA prescribed responsibilities*

The PRA has made it clear where a firm allocates a PRA Prescribed Responsibility to more than one Senior Manager each of those individuals will, in principle, be deemed wholly responsible for it. PRA Prescribed Responsibilities can therefore be shared but not split among two or more Senior Managers.

*FCA prescribed responsibilities*

Broadly speaking, the FCA is fully aligned with the PRA in relation to the sharing of the whole of a prescribed responsibility by two or more individuals. This is because many of the FCA's Prescribed Responsibilities form a subset of the PRA's. However, where FCA Prescribed Responsibilities is concerned, their position differs slightly. The FCA accepts there will be limited circumstances where *dividing* a FCA Prescribed Responsibility may be appropriate, providing the firm can confirm that no gaps in the allocation of responsibilities arise as a result. Firms will also need to think carefully about the responsibilities of each individual in any such situation and make sure that these are appropriately reflected in Statements of Responsibilities and responsibilities maps. The firm's map would also need to show there are no gaps as a result of the division of responsibility. The FCA holds each individual responsible for the aspects of the responsibility assigned to them. Where it is unclear who is responsible all SMF managers with the relevant responsibility would be considered jointly responsible.

*Assigning overall responsibility for an area*

Firms are expected to consider the overall responsibilities of their Senior Managers, relating to the activities, functions and area of their business. In some cases, responsibilities may be obvious, however in other cases, it may depend upon the particular way the firm is organised.

A firm is not required to assign overall responsibility additionally for those areas where Prescribed Responsibilities exist and are assigned to senior managers. In addition, overall responsibility does not have to be assigned for responsibilities required or allocated as part of various SMFs. For example, there would be no need to record that an individual has overall responsibility for Internal Audit if a firm has a SMF5 Head of Internal Audit. Thirdly, overall responsibility provisions do not apply to NEDs.

Given the SMR has no territorial limitation, under the overall responsibility rules firms must allocate responsibility to a senior manager for all activities, business areas and management functions of the whole firm, including those carried out, whether in part or in full, from a branch overseas.

The SMR applies to legal entities individually, rather than to a banking group as a whole. When considering which individual has overall responsibility for a particular area or function, firms will need to ensure that they identify the individual who is genuinely accountable in regard to the entity in question, regardless of whether or not he or she is a director or employee of that particular entity.

#### *Individuals located outside the UK*

There may also be situations where an individual based outside a relevant firm is performing an SMF directly on behalf of the firm. In those situations, the individual will require approval by the FCA or PRA for the relevant SMF. An individual not directly employed by a relevant firm but whose influence over it meets the relevant test must be specifically approved as a SMF7 Group Entity Senior Manager. Such individuals may be based overseas, however being physically located outside the UK does not mean they cannot perform an SMF. Indeed, a UK firm with one or more overseas branches may have senior managers based overseas who are responsible for managing the overseas establishments. Whether they should be approved as an SMF will depend on the role they are undertaking in respect of the UK firm. In such cases, it is important for a firm to make sure that its Statement of Responsibilities clarifies the nature of an individual's responsibilities, and any areas of the firm that it oversees. In considering whether an individual requires approval for the Group Entity Senior Manager function, firms will need to think carefully about how responsibilities are allocated so they can ensure that the governing body of the firm is, and will remain, effective.

*Guidance on the roles and responsibilities of NEDs*<sup>12</sup>

The only NEDs that require pre-approval as senior managers by the PRA or FCA are the Chairman, Senior Independent Director and the Chairs of the Risk, Audit, Remuneration and Nomination Committees. The PRA has also issued rules in respect of notification requirements for non-approved, or 'notified' NEDs, i.e. those who are not performing an SMF. Individuals that will be performing notified NED roles from commencement do not need to be grandfathered and their approval will lapse at this stage.

Interestingly, notified NEDs are not required to comply with the Certification Regime and Conduct Rules. However, both approved and notified NEDs will continue to be subject to the statutory and fiduciary duties of directors under the UK Companies Act 2006. Both academics and practitioners in the UK have observed the different treatment of approved and notified NEDs under the regimes will likely create a two-tier board. The British Bankers Association (BBA) has called upon the FCA and PRA to recognise this could result in unintended consequences for board dynamics and board structures.<sup>13</sup> Meanwhile, the PRA has sought to circumnavigate this potential dilemma by requiring firms to ensure notified NEDs observe certain Conduct Rules.<sup>14</sup> The PRA would not be able to apply these rules directly to notified NEDs in the way that they apply to an approved NED. However, a firm should be able to enforce these standards, for example, by writing a requirement into its Staff Handbook or Code, or otherwise make it a condition of employment or appointment.<sup>15</sup> The PRA has also reiterated that the Board as a whole must oversee ongoing compliance with its Threshold Conditions and other high level rules.

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<sup>12</sup> See Consultation Paper FCA CP15/5\*\*\* PRA CP7/15, 'Approach to non-executive directors in banking and Solvency II firms & Application of the presumption of responsibility to Senior Managers in banking firms', February 2015

<sup>13</sup> See the BBA and the Association for Financial Markets in Europe's (AFME) 'A joint response to the PRA and FCA's joint consultation on the Approach to non-executive directors in banking and Solvency II firms & Application of the presumption of responsibility to Senior Managers in banking firms', April 2015. (<https://www.bba.org.uk/policy/financial-and-risk-policy/hr/bba-and-afme-response-to-the-fcapra-consultation-on-the-approach-to-neds-in-banking/>)

In their joint response, the BBA says it would welcome continued dialogue with the regulators to ensure any unintended consequences are identified and can be appropriately managed and would encourage the PRA and FCA to monitor the impact of the new regime on board room composition and structure.

<sup>14</sup> Individual Conduct Rules 1–3 and Senior Management Conduct Rule 4 (see Table C – Conduct Rules below)

<sup>15</sup> Ibid n2

*Allocating responsibilities in practice*

A firm will need to identify the activities it conducts that are caught by the new SMR and then allocate responsibilities, in accordance with both PRA and FCA rules. For a smaller firm, this may be quite a different task to that for a larger firm, but some of the same basic elements will be involved:

- a. Identify those individuals that hold core SMFs 1 to 17 as set out in table A;
- b. Allocate the Prescribed Responsibilities that are relevant to the firm's activities to the individual Senior Managers identified;
- c. Identify the overall responsibilities of senior individuals for any other activities, functions or business areas of the firm. If there are any not already assigned as SMF1 to 17, they will require approval for SMF18.

In some cases, firms may also need to identify other responsibilities allocated, in addition to those described above. For example, there could be responsibilities that are outside the normal course of business such as those linked to high profile projects or initiatives.

Firms will need to record the allocation of responsibilities on individual Statements of Responsibilities and provide a summary of these in the firm's responsibilities map. This should include any other information that is relevant to the controlled function they perform. Firms are expected to combine all their Statements of Responsibilities in a single document, which they may update as appropriate or necessary. This may be submitted to the FCA electronically. Firms are given a 300 indicative word limit to describe each responsibility. Examples of necessary updates include the re-allocation or removal of one of the Prescribed Responsibilities or a change in the way a responsibility has been shared among more than one person.

*Statutory duty of responsibility*

The Financial Services (Banking Reform) Act 2013 introduced the "Presumption of Responsibility" for senior managers.<sup>16</sup> This means when a firm breaches a relevant requirement, the senior manager with responsibility for the management of the firm's activities which relate to the breach, is guilty of misconduct unless they satisfy either the FCA or PRA that they took such steps as a person in their position could reasonably be expected to take to avoid the breach occurring (or continuing).

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<sup>16</sup> The Financial Services (Banking Reform) Act 2013 implemented these changes by inserting new sections 66A (5) and (6) and 66B (5) and (6) of FSMA 2000.

This is otherwise known as the reversal of the burden of proof.<sup>17</sup> Previously the burden was on the regulator to show that the individual was “knowingly concerned” in the firm's breach.

The “Presumption of Responsibility” was consulted on in the FCA’s Consultation Paper, CP15/09 published in March 2015.<sup>18</sup> However, given its controversy, it has now been replaced with a statutory duty of responsibility. On 14 October 2015, the UK Treasury introduced the Bank of England and Financial Services Bill (the “Bill”)<sup>19</sup> which contains a statutory duty of responsibility for senior managers to take all steps as they could reasonably be expected to take to avoid a regulatory breach from occurring (or continuing). A senior manager is guilty of misconduct if he or she did not take all steps as they could reasonably be expected to take to avoid a regulatory breach from occurring (or continuing). It will now be for the regulators to prove that such steps were not followed.

### *New criminal offence*

The Financial Services (Banking Reform) Act<sup>20</sup> introduced a new criminal offence of failing to take reasonable steps to prevent the failure of the financial institution.<sup>21</sup> This offence only applies to senior managers working in UK banks, building societies and PRA-designated investment firms (but not UK branches of overseas firms). This is a strict liability offence, which automatically arises in the event of failure. “Failure” is defined as entering insolvency, having to be stabilised under the Banking Act, or being unable to satisfy claims under the Financial Services Compensation Scheme. The test for culpability is recklessness, based on an objective standard of what would reasonably be expected of a person in his or her position. Senior managers will

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<sup>17</sup> The reversal of the burden of proof currently exists in sexual harassment and racial discrimination cases in the UK, but impacts firms rather than individuals. For example, section 136(2) and (3) of the Equality Act 2010 provides for a two stage reverse of burden of proof process. At the first stage the claimant must prove on the balance of probabilities a prima facie case of discrimination. If the claimant establishes a prima facie, the burden of proof then shifts to the respondent. At this stage the respondent must prove that there was no conscious or sub-conscious discriminatory intent behind their conduct.

<sup>18</sup> Strengthening accountability in banking: a new regulatory framework for individuals – Feedback on \*\*\*FCA CP14/13 / PRA CP14/14 and consultation on additional guidance, March 2015

<sup>19</sup> On 14 October the Bill passed the first reading stage in the House of Lords. The second reading took place on 26 October 2015. This second reading involved a general debate on all aspects of the Bill.

<sup>20</sup> Section 36 of the Financial Services (Banking Reform) Act 2013

<sup>21</sup> This new offence was discussed previously in ‘Consultation Paper FCA CP14/13/PRA CP14/14 ‘Strengthening accountability in banking: a new regulatory framework for individuals’, dated July 2014 and ‘Consultation Paper FCA CP15/5 PRA CP7/15 Approach to non-executive directors in banking and Solvency II firms & Application of the presumption of responsibility to Senior Managers in banking firms’ dated February 2015

therefore need to be in a position to evidence that they took reasonable steps to prevent the failure of the financial institution.

The industry considers the potential for criminal prosecution, even if remote, will remain a deterrent to the taking up by suitably qualified, risk-averse individuals of approved NED roles. Hence, the BBA has requested the FCA and PRA to provide examples of circumstances in which an approved NED could reasonably be held liable for a criminal offence.<sup>22</sup> In their policy statement<sup>23</sup>, the PRA declined to publish hypothetical scenarios, given the conditions for the offence to apply are clearly set out in the Financial Services (Banking Reform) Act 2013.

## **Fitness & Propriety and the Certification Regime**

### *Introduction*

The Certification Regime applies to staff that could pose a risk of significant harm to the firm or any of its customers, for example, senior management, risk takers, staff in control functions, investment advisers, brokers or staff that administer benchmarks, who are subject to the Remuneration Code (SYSC 19D).<sup>24</sup>

### *Fitness and propriety*

The responsibility for the assessment of fitness and propriety rests with firms. Firms will be required to put in place procedures for assessing the fitness and propriety of staff that carry out 'significant harm' functions, both at the point of recruitment and on an ongoing basis, for which they will be accountable to the regulators. These preparations will be important not only when recruiting for roles that come under the Certification Regime but when reassessing every year the fitness and propriety of staff who are subject to the Certification Regime. Firms are not expected to assess, independently of this, whether or not any other staff outside the scope of certification functions set out in the FCA rules could be in a position to pose significant harm.

Fitness and propriety should be assessed relative to an individual's role, or seniority, which is inherent in both the Certification Regime and the FCA's requirements on Fitness and Propriety more generally. Firms are not required to adopt the same criteria for fitness and propriety regardless of the particular role for which an individual is being assessed. Hence, firms are expected to act in a proportionate manner.

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<sup>22</sup> Ibid n13

<sup>23</sup> Ibid n2

<sup>24</sup> <https://fshandbook.info/FS/html/handbook/SYSC/19D>



### *Regulatory references*

For the new regime to work effectively, firms have been recommended to embrace their obligations, particularly when it comes to providing employee references for staff that apply for senior management positions or certification functions at other firms. These references would need to disclose any facts that led a previous employer to conclude that the candidate breached a Conduct Rule and a description of the basis and outcome of disciplinary action taken in relation to any such breach. The FCA rules do not require firms to carry out criminal record checks, however firms may still choose to employ checks for staff that are not applying for positions under the SMR, where they are legally permitted to do so.

The FCA sees regulatory references as an important tool in the effort to raise standards and ensure that individuals take responsibility for their own conduct. As a result, they will ensure that any revised requirements, including where applicable a template, are in place ahead of commencement.

### *Wholesale market activities*

As explained above, the FCA is also in the process of consulting on extending the Certification Regime to individuals involved in wholesale market activities. For example, given the extensive use of algorithms in the UK market, the FCA proposes to add a further category of significant harm function to capture algorithmic trading within the Certification Regime. Individuals responsible for the deployment of trading algorithms will be required to be fit and proper, for example to ensure that the algorithms are adequately tested to assess their potential behaviour, to ensure they are resilient and do not contribute to disorderly markets or breach market abuse or trading venue rules. Further details on the FCA's proposals for extending the Certification Regime are provided in Chapter 6 of the Consultation Paper.

For firms that will be subject to the new accountability regime, individuals who currently require FCA approval for either the benchmark submission function or the benchmark administration function will now fall under the Certification Regime (unless they require approval for a SMF for another reason). As a result, when the new regime commences, approvals granted previously in relation to benchmarks will not apply.

In addition, the FCA has been heavily involved in the work of the Fair and Effective Markets Review (FEMR), which has now published a final report. The review focused on raising standards in fixed income, currency and commodity (FICC) markets. Central to its recommendations is the potential for expansion of the SMR and Certification Regime to these markets. Further



to considering feedback provided to the review and the recommendations of the final report, the FCA plans to consult on changes to their rules and guidance on regulatory references.

## The Conduct Rules

### *Introduction*

The Conduct Rules are high-level requirements reflecting the core standards expected of staff working in banks and other relevant firms. The rules are to be set out in the FCA's Code of Conduct sourcebook ("COCON").<sup>25</sup> The Conduct Rules are drawn from the FCA Principles for Business: acting with integrity, skill, care and diligence; being open and cooperative with regulators; paying due regard to the interest of customers; and observing proper standards of market conduct.<sup>26</sup> The FCA Conduct Rules, are provided in Table C below. Firms' preparations will need to include ensuring that staff, who will be subject to the new rules, are aware of the conduct rules and how they apply to them.

*Table C - Conduct Rules*

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

Individuals subject to either the SMR or the Certification Regime will be subject to the Conduct Rules and the COCON from commencement, while firms will have a further year, until 7 March 2017, to prepare for the wider

<sup>25</sup> See Individual Accountability Instrument 2015, Section 2 *Conduct Rules*.  
([http://media.fshandbook.info/Legislation/2015/FCA\\_2015\\_31.pdf](http://media.fshandbook.info/Legislation/2015/FCA_2015_31.pdf)).

<sup>26</sup> COCON is the Code of Conduct for Staff sourcebook, part of the Handbook in the High Level Standards.

application of the Conduct Rules to other staff. Firms should ensure that other staff is trained in the Conduct Rules and how they relate to their role in advance of this date. Firms will be expected to make their first annual submission notifying breaches of the Conduct Rules, including staff who are not within the SMR or Certification Regime at the end of October 2017.

The Conduct Rules allow firms to report suspected and actual breaches on an annual basis. However, where a Senior Manager under the SMR is concerned, firms are required to submit actual or suspected breaches of the Conduct Rules within seven business days of the firm becoming aware of the actual or suspected breach. Meanwhile, actual or suspected breaches of the Conduct Rules by any other staff who are subject to them will be required annually. Firms will therefore be able to assess, in many more cases, whether or not a suspicion is founded before reporting it. Only suspicions that are either proven or that remain open at the time of reporting will need to be included. In addition, firms have the ongoing requirement to notify the FCA and PRA of matters of which it would reasonably expect notice and specifically of a significant breach of a rule.

#### *Wider range of enforcement options*

The introduction of the Conduct Rules and COCON is likely to have the most significant and wide-ranging impact on banks, relevant firms and their employees as a whole. The Conduct Rules will apply to all bank employees who fall within the regimes. This means that the vast majority of individuals working within banks, including the in house legal, Compliance and human resources functions will be subject to and required to comply with the new Conduct Rules.

If an individual breaches one or more of the Conduct Rules, the FCA and/or the PRA may take enforcement action against them personally. The introduction and broad application of the new Conduct Rules will be a significant change for banks and relevant firms. Firms will have to provide regular and comprehensive training to their employees on the new Conduct Rules, and a much larger number of employees may be exposed to the risk of possible FCA enforcement action if they are found to have breached the Conduct Rules.

### **Transitional arrangements**

The UK HM Treasury has published a Commencement Order<sup>27</sup> and a Transitional Order<sup>28</sup> which sets out the timing and transitional arrangements for the new regime. The key features of these arrangements are:

- An individual who has been approved under the current APER and is transferring to an equivalent function under the new regime would not need to apply for a fresh approval for the relevant SMF, provided that a notification is submitted to the appropriate regulator, accompanied by a firm responsibilities map, and a Statement of Responsibilities for each individual who is grandfathering to the new regime. The requirements of the new regime, including Conduct Rules, will apply to these individuals from commencement. Firms will have to submit their grandfathering notifications for these individuals by 8 February 2016.
- Firms must identify individuals who will perform SMFs (and which therefore fall within the Certification Regime) by commencement, at which point they will become subject to the Conduct Rules. Firms will, however, have until 7 March 2017, one year from commencement in which to issue certificates of fitness and propriety to these individuals. This timetable is designed to accommodate all firms' annual appraisal cycles. The FCA expects the regular annual fitness and propriety assessments required for certified persons to become part of the existing annual appraisal process.
- All other individuals who will be subject to the Conduct Rules will become so one year after commencement.

### **Conclusion and analysis**

Banks and other relevant firms are now facing an incredibly onerous task in the forthcoming months preparing for a fundamental overhaul of the regulatory framework for all individuals working within their firms. This has broadly stemmed from a string of banking conduct failures and the lack of individual accountability and discipline under the current APER regime.<sup>29</sup> These have led to a shattering of public confidence in the banking industry. The PCBS said in their Report:

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<sup>27</sup> The Financial Services (Banking Reform) Act 2013 (Commencement No. 9) Order 2015

<sup>28</sup> The Financial Services (Banking Reform) Act 2013 (Transitional and Savings Provisions) Order 2015

<sup>29</sup> For further discussion see: Making individuals accountable: new regulatory frameworks for banking and for insurers, Jenny Stainsby and Karen Anderson, Compliance Officer Bulletin 2015

*“One of the most dismal features of the banking industry to emerge from our evidence was the striking limitation on the sense of personal responsibility and accountability of the leaders within the industry for the widespread failings and abuses over which they presided. Ignorance was offered as the main excuse. It was not always accidental. [ ] Senior executives were aware that they would not be punished for what they could not see and promptly donned the blindfolds. Where they could not claim ignorance, they fell back on the claim that everyone was party to a decision, so that no individual could be held squarely to blame - the Murder on the Orient Express defence.”<sup>30</sup>*

The PCBS further said:

*“It is imperative that in future senior executives in banks have an incentive to know what is happening on their watch - not an incentive to remain ignorant in case the regulator comes calling.”<sup>31</sup>*

The new regimes endeavour admirably to ensure that senior managers and staff at all levels are incentivised to know and understand the activities within their business areas for which they have individual responsibility. The requirement to allocate and map out responsibilities and prepare Statements of Responsibilities for individuals is particularly helpful for this purpose.

However, it is suggested in order for the regimes to be effective, the new Conduct Rules should be sufficiently free from ambiguity so individuals know with certainty whether they are falling foul of regulatory requirements. In particular, the requirement for senior managers to take ‘reasonable steps’ having regard to their existing statutory, common law and equitable obligations, including those set out in the UK Companies Act 2006, the Conduct Rules, the UK Corporate Governance Code<sup>32</sup>, and the Model Code<sup>33</sup>, may not go so far as to provide the desired level of certainty.

Furthermore, it remains to be seen whether some of the more draconian amendments are entirely necessary or even desirable. For example, the introduction of a criminal offence for senior managers remain controversial. The industry has argued that increasing the burdens of senior managers to such a degree will only lead to a *diaspora* of senior management talent from the UK to other international financial centres, such as Hong Kong or Singapore.<sup>34</sup> Similarly, the industry has raised concerns the difference in

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<sup>30</sup> PCBS Report para.105

<sup>31</sup> PCBS Report para.564

<sup>32</sup> <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>

<sup>33</sup> <http://fshandbook.info/FS/html/handbook/LR/9/Annex1>

<sup>34</sup> See: Out of proportion, Karen Anderson, Law Society’s Gazette, 2013, 110(27), 9

potential regulatory liability of approved NEDs and notified NEDs may make taking on the role of an approved NED less appealing, potentially making it more difficult for firms to attract suitable candidates for these roles.<sup>35</sup> Whilst, the impact of these changes remains to be seen, the industry can only hope the regulators enforce the regimes in a proportionate manner.

Finally, there is a broader and persuasive argument that increasing the number of detailed rules and procedures, or *burdens*, may distract individuals from exercising, or even cause *atrophy*, of sound professional judgement, which in turn may lead to perverse and unintended consequences.

Whilst sharpening individuals' observance of the rules and procedures, may strengthen individual accountability, it may not necessarily lead to improved culture, professionalism and ultimately trust and confidence in the UK banking sector.<sup>36</sup> Thus, there is also a keen and widespread expectation for the UK banking industry to positively and demonstrably raise its ethical standards, without necessarily the external stimulus of onerous rules and regulations.<sup>37</sup>

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<sup>35</sup> Ibid n12

<sup>36</sup> FT View 'Regulation alone will not restore faith in markets'. The Financial Times. 26 May 2015. (<http://www.ft.com/cms/s/0/8a41dd82-0399-11e5-a70f-00144feabdc0.html#axzz3mTmuNnMm>)

<sup>37</sup> The BSB has been established with the purpose of promoting high standards across banks and building societies in the UK. This new independent body, proposed by the Lambert Review and recommended by the PCBS is designed to create a sense of vocation in banking by promoting high standards of competence and behaviour across the UK industry. The BSB will complement the work of regulators by setting out an aspirational single principles-based code of practice. For more information go to: <http://www.bankingstandardsboard.org.uk/>.