

REFORM OF PERSONAL ACCOUNTABILITY IN BANKS AND BUILDING SOCIETIES

Financial Services

The Approved Persons Regime “created a largely illusory impression of regulatory control over individuals”, where “they [Approved Persons] faced little prospect of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated”

PCBS

Introduction

On 30 July 2014, the Prudential Regulation Authority (“**PRA**”) and the Financial Conduct Authority (“**FCA**”) (together, “the **regulators**”) published two joint consultation papers (the “**CPs**”) aimed at improving individual responsibility and accountability in the banking sector by introducing a Senior Manager and Certification Regime, building on the primary legislation in the Financial Services (Banking Reform) Act 2013 (the “**Banking Reform Act**”) (together, the “**New Regime**”).

The New Regime represents a significant reform of the regime regulating individuals working in banks and building societies. Certain of the proposals of the New Regime flow from the recommendations of the Parliamentary Commission on Banking Standards (“**PCBS**”) which, in June 2013, recommended a series of measures to restore trust and improve culture in banks, following what it considered to be a failure of the existing Approved Persons Regime.

Alongside the CPs, the PRA consulted on proposed changes to the Remuneration Code; principally that the minimum period for which variable remuneration should be subject to clawback (and malus provisions) be increased to 7 years for senior managers (and extending the clawback period for senior managers further still to 10 years in certain circumstances) and 5 years for other material risk takers.

What is the practical impact of the New Regime?

The New Regime will have a broad and deep impact; a high percentage of a firm’s staff will be brought within scope, and directors and other senior managers will be focused on their increased personal liabilities. Key impacts include:

Gap analysis: the need to survey firms’ current arrangements and undertake a gap analysis to determine who will fall under the New Regime, and in order to complete the Management Responsibilities Map (see later).

Governance systems and controls: the need to put in place appropriate governance systems and controls related to policies; regulatory reporting; training; assigning responsibility for the production of reports; and demonstrating to the regulators that systems and controls are robust and effective.

Significantly widened scope: All employees (other than prescribed ancillary employees) would be personally liable to the FCA in connection with their compliance with the new Code of Conduct. This will give rise to a number of issues for the human resources function. In particular, there is likely to be an increased incidence of notifications to regulators - where they “know or suspect” there has been a breach of the Code of Conduct.

Statements of responsibility: the need to draft statements of responsibility (see later) for those carrying on an Senior Management Function (“**SMF**”) and having systems in place for responding to requests from the PRA / FCA for personal attestations from such individuals.

Risk aversion: the New Regime may result in individuals being discouraged from taking senior roles; greater risk aversion in the business; more defensive decision-making; and greater reliance on external advice.

Institutionalising risk reviews: firms should consider practical steps that they can take to mitigate their liability and that of their senior managers, in particular, in connection with the reversed burden of proof for disciplinary action. This is likely to give rise to an increased need for initial, periodic and 'handover' reviews of governance and risk. The judgment of the Upper Tribunal (Tax and Chancery Chamber) in the case of *John Pottage v FSA* has established a regulatory expectation that senior management should undertake reviews and assessments of governance, and risk in the business for which they are responsible on an initial and periodic basis. These reviews may also become common at the handover of a function as exiting managers seek to protect their position in the context of providing handover statements. Reliance on such reviews and assessments has further increased in recent years by reason of requests from the regulators for personal attestations in order to gain commitments from approved persons that a compliant state of affairs exists, or that specific action has been taken or will be taken.

Employment law impact: there may be a need to amend employment contracts and procedures, including indemnities, D&O type insurance, legal representation at meetings, employee access to relevant documents during and after leaving a role, notification of disciplinaries to regulators, the handling of reference requests and record keeping.

Remuneration Code relationship: need to consider how the developing responsibilities interact with the Remuneration Code responsibilities.

Corporate Governance disruption: need to consider the interaction of the New Regime with corporate governance principles. Where does the buck actually stop? Given the increased focus on individual responsibility and liability, there will be a tension with board responsibility and collective decision-making. The PRA states that it: "does not expect senior managers to have ultimate authority over the areas they manage; ultimate authority and responsibility will continue to rest with the board", so firms should anticipate an increased incidence of decisions being raised to the board, and more dissent amongst SMFs.

Who will the New Regime apply to?

Currently, it is only proposed that most aspects of the New Regime, in particular, the Senior Manager and Certification Regime would apply to UK incorporated deposit-takers (banks, building societies and credit unions) and investment firms dealing as principal who are PRA-regulated.

The regime would also apply to branches of non-UK incorporated institutions in a "proportionate and appropriate way" but the regulators' thinking on non-UK deposit-takers operating in the UK is still being formalised. In time, the new Regime could be a model for the rest of the financial services industry – with suggestions that insurers will be next in line – and could ultimately replace the Approved Persons Regime entirely. There are currently, however, no immediate plans for it to do so.

The population covered by the New Regime will primarily be determined by the rules made by the PRA. The scope of the FCA rules then includes certain additional individuals.

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When will the New Regime apply?

The CPs with the draft rules are open for consultation until the 31 October 2014. The PRA and FCA hope to publish policy statements containing their respective final rules by the end of 2014 with the intention that these final rules (together with Part 4 of the Banking Reform Act) should apply from sometime in 2015.

What are the key elements of the Senior Managers and Certification Regime which will impact the way in which individuals are regulated?

Building on the powers set out in the Banking Reform Act, the CPs propose:

The Senior Managers Regime

A Senior Managers Regime would replace the Approved Persons Regime as it applies to persons who currently have Significant Influence Function (“SIF”) responsibility. The new regime will apply to persons carrying on a SMF (anticipated by the regulators to largely be the same as current SIFs) within, broadly, PRA-regulated firms (other than insurance companies).

PRA SMFs would include the Chief Executive; Chief Finance function; Chief Risk function; Head of Internal Audit; Group Entity Senior Manager (where “significant influence”); Head of Key Business Area, as well as certain key non-executive roles. Some roles may not be necessary for smaller non-complex entities.

The PRA proposes to introduce a Head of Key Business Area SMF which cover individuals managing a business area or division so large in relative terms to the size of the firm that it could jeopardise the firm’s safety and soundness, and so substantial in absolute terms that it warrants its own SMF (even though the Senior Manager performing it may report to the Chief Executive or another SMF). An individual will require approval as a Head of Key Business Area if they manage an area with gross total assets of £10bn or more which accounts for either 20% of the firm’s or, where the firm is part of a group, 20% the group’s gross revenue.

FCA SMFs would include the Compliance Oversight function; MLRO; as well as all board members that are not designated as PRA SMFs,

Firms will have a legal obligation to pre-vet applicants applying to become SMFs and annually to reappraise the fitness of their senior managers.

The regulators have the power to subject senior management approval to conditions or time limitation, for example, approving an SMF subject to a training requirement or imposing a probationary time limit on an approval.

PRA PRESCRIBED RESPONSIBILITIES

- | | |
|--|--|
| <ul style="list-style-type: none"> ▶ Performance by the firm of its obligations under their senior management regime, including implementation and oversight ▶ Performance by the firm of its obligations under the Certification Rules ▶ Compliance with the rules relating to the firm's management responsibilities map ▶ The induction, training and professional development of all persons performing senior management functions on behalf of the firm and all members of the firm's management body ▶ Ensuring and overseeing the integrity and independence of the internal audit function in accordance with SYSC 6.2 (internal audit) ▶ Ensuring and overseeing the integrity and independence of the compliance function in accordance with SYSC 6.1 (Compliance) ▶ The firm's treasury management functions ▶ The production and integrity of the firm's financial information and its regulatory reporting in respect of its regulated activities ▶ The firm's recovery plan and resolution pack and overseeing the internal processes regarding their governance ▶ 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 7.1.2R to SYSC 7.1.5R satisfy the requirements of those rules and are consistently effective in accordance with SYSC 4.1.1R | <ul style="list-style-type: none"> ▶ Ensuring and overseeing the integrity and independence of the risk function in accordance with SYSC 7.1.22 R (Risk control) ▶ Ensuring and overseeing the integrity, independence and effectiveness of the firm's policies and procedures on whistleblowing and for ensuring staff who raise concerns are protected from detrimental treatment ▶ Allocation of all prescribed responsibilities ▶ Leading the development of the firm's culture and standards in relation to the carrying on of its business and the behaviours of its staff ▶ Embedding the firm's culture and standards in relation to the carrying on of its business and the behaviours of its staff in the day-to-day management of the firm ▶ The development and maintenance of the firm's business model ▶ 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: ▶ Supervision and management of the work of outsourced internal auditors; and ▶ Management of potential conflicts of interest between the provision of external audit and internal audit services ▶ If the firm does not have a person who performs the Senior Independent Director function: ▶ Carrying out oversight of the person who performs the Chairman function; and ▶ Oversight of the adequacy and quality of the resources available to the office of that person to enable the role to be fulfilled within the firm ▶ If the firm carries out proprietary trading, the firm's proprietary trading activities |
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Statement of Responsibilities

Firms must provide Statements of Responsibility for SMFs "setting out the aspects of the affairs of the authorised person concerned which it is intended that the person will be responsible for managing in performing the function". The regulators also propose allotting "prescribed responsibilities" and "key functions" to those carrying on a SMF which would facilitate enforcement action.

PRA SMFs would have "inherent responsibilities" described by the rules, e.g. the Chief Executive function (SMF1) is described as "the function of having responsibility, under the immediate authority of the management body, alone or jointly with others, for carrying out the management of the conduct of the whole of the business (or relevant activities) of a firm"; and would also be allotted some of the 20 prescribed responsibilities which would be shared amongst them - see table above.

FCA SMFs would have some specific responsibilities but would also be allotted some of the 27 key functions set out in the table below. According to the FCA's

approach, the top 8 items from the list of Prescribed Responsibilities would need to be allocated to an SMF (other than a Significant Responsibility Senior Manager) but the 27 key functions and “identified risks” (derived from the PRA’s Internal Capital Adequacy Assessment; or relevant sections of SYSC 4 & 7) could be allocated to a person with overall responsibility below board level: the Significant Responsibility Senior Manager, where they are primarily responsible for reporting to the board in respect of that function.

Mapping Responsibility - the Management Responsibilities Map

A firm must, at all times, have a comprehensive, up-to-date, and single document (the Management Responsibilities Map) that describes its management and governance arrangements, including:

- ▶ Details of the reporting lines and the lines of responsibility
- ▶ Reasonable details about the persons who are part of those arrangements and their particular responsibilities.

The purpose of the Management Responsibilities Map is to help the firm and the regulators satisfy themselves that the firm has a clear organisational structure (as required by SYSC) with no gaps in accountability; and to help the regulator(s) to identify “who it needs to speak to about particular issues and who is accountable if something goes wrong”.

Handover requirements

A firm must take all reasonable steps to ensure that:

- ▶ a person who is becoming an SMF manager
- ▶ an SMF manager whose responsibilities are being changed
- ▶ anyone who has management or supervisory responsibilities for the SMF manager above
- ▶ has, when the SMF manager starts to perform his new responsibilities, all information and material that a person in such a position could reasonably expect to have to perform his responsibilities effectively and in accordance with the requirements of the regulatory system.

The information and material includes details about unresolved or possible breaches of the requirements of the regulatory system and of any unresolved concerns expressed by the FCA, the PRA or another regulatory body.

The CPs suggest that a handover note should be a practical and helpful document, and that it should include an assessment of what issues should be prioritised, containing judgment and opinion, not just facts and figures.

The firm should take reasonable steps to ensure that the predecessor contributes to the information and material everything that it would be reasonable to expect the predecessor to know and consider relevant, including the predecessor’s opinions. The CPs provide that: “one way of doing this would be for the predecessor to prepare a handover certificate”.

FCA KEY FUNCTIONS

- ▶ Establishing and operating systems and controls in relation to financial crime
- ▶ Safekeeping and administration of assets of clients
- ▶ Payment services
- ▶ Settlement
- ▶ Investment management
- ▶ Financial or investment advice
- ▶ Mortgage advice
- ▶ Corporate investments
- ▶ Wholesale sales
- ▶ Retail sales
- ▶ First line quality assurance of sales
- ▶ Trading for clients
- ▶ Investment research
- ▶ Origination/syndication and underwriting
- ▶ Retail lending decisions
- ▶ Wholesale lending decisions
- ▶ Design and manufacturing of products intended for wholesale customers
- ▶ Design and manufacture of products intended for retail customers
- ▶ Production and distribution of marketing materials and communications
- ▶ Customer service
- ▶ Customer complaints handling
- ▶ Collection and recovering amounts owned to a firm by its customers/dealing with customers in arrears
- ▶ Middle office
- ▶ The firm's information technology
- ▶ Business continuity
- ▶ Human resources
- ▶ Incentive schemes for the firm's staff

Certification Regime

A new Certification Regime is introduced for the population of staff within a bank who perform a function which either regulator believes could pose 'significant harm' to the firm or any of its customers. The current proposals include 'material risk takers', former SIFs who are not SMFs, customer-facing roles subject to a qualification requirement and anyone who supervises a certified person who is not a SMF as being significant harm functions. They include, for example, the heads of legal, compliance and human resources.

Whilst such individuals would not be subject to regulatory approval in the way that an SMF would need approval, it will be for firms to implement an internal certification process which would determine on an annual basis that the population of staff subject to the certification regime remain fit and proper for their roles.

The fit and proper standards expected to be met by certified persons will be the same as for SMFs, and firms would have to take reasonable care to ensure that no person performing significant harm function does so unless they have been certified them as fit and proper. This may have employment law consequences if an individual can no longer perform their role if they are not able to be certified by their employer as being fit and proper.

“The Banking Reform Act reverses the burden of proof, such that, in order to avoid a penalty, a senior manager who was responsible for the management of the firm’s activities where a contravention occurred would have to show that they [had taken reasonable steps to take to avoid the contravention occurring]”.

New Code of Conduct

There are a new set of Conduct rules in the Code of Conduct sourcebook (“C-CON”) which will replace the Statements of Principle and Code of Practice for Approved Persons (“APER”). There are two notable innovations in this regard:

The addition of two conduct rules to the existing 7 APER principles:

- ▶ “You must pay due regard to the interests of customers and treat them fairly”
- ▶ applying only to SMFs: “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”.

Five of the conduct rules will apply to ALL employees of the firm (other than purely ancillary staff such as secretaries, IT and security staff etc who are prescribed by the FCA). Further, the application of the conduct rules will not be limited to any “accountable functions” (“controlled functions”; and “any other functions in relation to the carrying on of a regulated activity” as currently is the case with respect to Approved Persons) but will rather apply to conduct in relation to the performance of functions relating to the carrying on of activities (whether or not regulated activities) by the individual’s employer (but only if in UK or with a UK client).

Firms must notify where they “know or suspect” there has been a breach of the Code of Conduct.

How would the New Regime enable disciplinary action against individuals?

Reversed burden of proof

The Banking Reform Act reverses the burden of proof, such that, in order to avoid a penalty, a senior manager who was responsible for the management of the firm’s activities where a contravention occurred would have to show that they “had taken such steps as a person in [their] position could reasonably be expected to take to avoid the contravention occurring (or continuing)”. This is a significant development, overturning the existing requirement for the individual to be “personally culpable”. However, the FCA provides in the CPs that: “As with the current approach, sometimes it will be appropriate to take action against a Senior Manager, sometimes against a firm, and sometimes against both. These decisions are made on a case-by-case basis, applying the criteria set out in the DEPP”.

All employees subject to disciplinary regime

The regulators are given power to make rules which would apply to all employees of authorised persons; and would be able to take disciplinary action for a failure by all employees (except prescribed ancillary employees) to comply with new Conduct Rules. Disciplinary action by a firm against anyone subject to the Conduct Rules would be notifiable to the appropriate regulator. Details of Conduct Rules breaches and related disciplinary action would also be required in references.

New criminal offence

A new criminal offence for reckless decision-making causing an institution to fail. Attracting the moniker of the “Fred Goodwin offence”, it would apply where an individual took or agreed to take a decision regarding the running of a business, or failed to take a step to prevent such a decision being taken, and at the time of taking such a decision, the individual was aware of the risk that the decision may cause a failure of a group entity; and their conduct fell far below what could reasonably be expected of a person in their position. The new offence, which it is anticipated would be very difficult to prove, would be punishable to a term of imprisonment of up to seven years.

Extended limitation period

The limitation period in which the regulators can take disciplinary action against any approved person is extended from 3 to 6 years.

Will there be any transitional/grandfathering arrangements?

It is the intention of the regulators to “grandfather” all current SIFs to their equivalent SMFs under the New Regime where applicable. However, if the individual is intending to perform a new function that does not map to their current controlled function, they will be required to seek approval from the relevant regulator. In particular, the proposed SMFs of Head of Key Business Area (SMF6) and Significant Responsibility SMF (SMF18) may cover a wider category of persons than are currently SIFs. For instance, the current Significant Management controlled function (CF29) does not neatly map over to the SMF6 or SMF18 roles, as might be suggested by the indicative table provided in the CPs (see below). In particular, it is anticipated that many senior managers of overseas operations may be SMFs where before they were not SIFs.

Notwithstanding any grandfathering, firms would still need to prepare Statements of Responsibility for each individual who undertakes an SMF and this individual would need to feature in the firm’s Responsibilities Map. Further, the firm would need to prepare an attestation on how individuals who hold SIF positions would map across to new SMFs.

The CPs propose a transitional period of 12 months for firms to issue individuals with their first certificate of fitness and propriety under the new Certification Regime. In relation to the application of the new Conduct Rules it is proposed that there should be a six month transitional period for SMFs and those subject to the Certification Regime; while all other employees subject to the new Conduct Rules should benefit from a 12 month transitional period in order to give firms time to properly train such individuals, the majority of whom will not previously have been subject to APER.

FCA indicative mapping to the new regime

| CURRENT CONTROLLED FUNCTION | PRA SENIOR MANAGEMENT FUNCTIONS | | FCA SENIOR MANAGEMENT FUNCTIONS |
|-----------------------------------|--|---|---|
| DIRECTOR (CF1) | Chief Finance function (SMF2) Chief Risk function (SMF4) Head of Internal Audit (SMF5) | Head of Key Business Area (SMF6) Group Entity Senior Manager (SMF7) | Executive Director (SMF3) |
| NED (CF2) | Group Entity Senior Manager (SMF7) Credit Union Senior Manager (SMF8) Chairman (SMF9) Chair of the Risk | Committee (SMF10) Chair of the Audit Committee (SMF11) Chair of the Remuneration Committee (SMF12) SID (SMF14) | Chair of the Nominations Committee (SMF13) Non-executive Director Function (SMF15) |
| CHIEF EXECUTIVE (CF3) | Chief Executive (SMF1) Credit Union Senior Manager (SMF8) | | |
| COMPLIANCE OVERSIGHT (CF10) | | | Compliance Oversight (SMF16) |
| MONEY LAUNDERING REPORTING (CF11) | | | Money Laundering Reporting (SMF17) |
| SYSTEMS AND CONTROLS (CF28) | Chief Finance function (SMF2) Chief Risk function (SMF4) Head of Internal Audit (SMF5) | | |
| SIGNIFICANT MANAGEMENT (CF29) | Head of Key Business Area (SMF6) Group Entity Senior Manager (SMF7) | | Significant Responsibility SMF (SMF18) |

How can Addleshaw Goddard help?

Addleshaw Goddard's Financial Services, Employment Law and Litigation specialists can advise you on managing and approaches to mitigating the impact of the New Regime, and the additional liability it creates over and above the existing Approved Persons Regime.

As well as advising on the New Regime, we have a wealth of experience in conducting regulatory reviews of business functions so as to provide senior management the comfort that there are compliant systems and controls in place. Our approach is forensic, applying the minimum necessary resource required to provide you with appropriate assurance. However, where needed, we have access to a dedicated pool of over 100 specialist paralegals in our Transaction Support Team.

The product of our reviews is legally privileged which is an essential protection against third party disclosure, and an advantage that can only be afforded by law firms.

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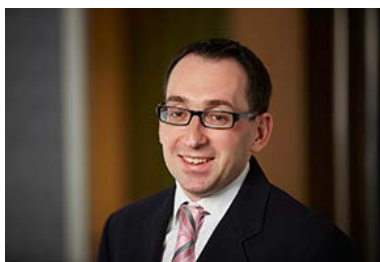
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