

August 2015

# SENIOR MANAGERS REGIME - PERSONAL ACCOUNTABILITY IN FINANCIAL SERVICES FIRMS

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How we can help you get ready

# THE NEW ACCOUNTABILITY REGIME

On 7 March 2016, the Prudential Regulation Authority (**PRA**) and the Financial Conduct Authority (**FCA**) will introduce a new senior managers and certification regime (**SMR**) to improve individual responsibility and accountability. This initiative derives from the recommendations of the Parliamentary Commission on Banking Standards, made to restore trust and improve culture in banks, following what it considered to be a failure of the existing Approved Persons Regime (**APR**) during the financial crisis. SMR applies to deposit-takers and large investment firms and extends (in a modified form) to foreign banks and Solvency II insurers. It will also be applied in due course to wholesale market activities to address misconduct which has come to light in the fixed income, currency and commodity markets.

There are also complementary changes to the Remuneration Code. The minimum period for which variable remuneration should be subject to clawback (and malus provisions) is to be increased to 7 years for senior managers (10 years in certain circumstances) and 5 years for other material risk takers.

For reasons of proportionality fewer requirements are to be placed on smaller firms (i.e. banks, building societies and investment firms with gross total assets of £250 million or less), a concession which is likely to help certain new challenger banks.

At Addleshaw Goddard, our business is about strong client relationships built on successful delivery across national and international markets. We are a premium business law firm offering an exceptional breadth of services. Our approach combines a deep understanding of our clients' businesses, markets and sectors with high calibre expertise, straight talking advice and a collaborative team culture. By delivering what clients want wherever they need it, from high value strategic advice, to the everyday, we pride ourselves on a service which is high quality, focused, relevant and consistently excellent.

*By understanding what really matters to clients, spending time in their markets and through finding new and better ways to deliver and price its services, clients report time and again that the firm's investment in them allied with first-rate technical expertise, sets Addleshaw Goddard apart.*

CHAMBERS UK DIRECTORY 2014

# WHAT ARE THE KEY ELEMENTS OF SMR?

## Senior Managers Regime

The SMR will replace the APR as it applies to persons who currently exercise significant influence functions ( **SIF**) in institutions with permission to accept deposits, PRA-investment firms with permission to deal in investments as principal and Solvency II insurers.

Between the PRA and the FCA's Rules, there are 17 senior management functions ( **SMF**) among which 30 prescribed responsibilities must be allocated. PRA SMFs will include Chief Executive; Chief Finance function; Chief Risk function; Head of Internal Audit, Group Entity Senior Manager and 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 Head of Key Business Area SMF6 covers individuals managing a business area or division so large (in relative terms to the size of a firm) that it could jeopardise the whole firm's safety and soundness, and so substantial in absolute terms that it warrants its own SMF, and who report to the Board (even though the senior manager performing it may report to the Chief Executive or another SMF).

FCA SMFs will include the Compliance Oversight function and Money Laundering Reporting function, as well as all Executive Director functions and the Chairman of the Board nominations committee. Further, individuals not on the Board who have overall responsibility for an activity, function or area not already allocated to an SMF will become a SMF18 – 'Other Overall Responsibility Function'.

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

## Certification Regime

A new Certification Regime is introduced for staff who perform a function which either regulator believes could pose "significant harm" to the firm or any of its customers. This group includes "material risk takers" (subject to the Remuneration Code), former SIF holders who are not SMFs, customer-facing roles subject to a qualification requirement and anyone who supervises a certified person who is not a SMF. The FCA is proposing to extend the scope of the Certification Regime to cover a broader range of current CF30s who deal with clients (probably in 2016).

These individuals will not be subject to regulatory pre-approval by regulators, rather, firms themselves must annually implement an internal certification process to determine that they remain fit and proper for their roles. The fit and proper standards for certified persons will be the same as for SMFs and firms must take reasonable care to ensure that no person performs a significant harm function unless they have been certified by the firm as fit and proper.

## Code of Conduct

The Statements of Principle and Code of Practice for Approved Persons (APER) will be replaced by a Code of Conduct. There are two notable innovations in the Code. The FCA will require those subject to the Code "to pay due regard to the interests of customers and treat them fairly"; and 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 be applied by the FCA to ALL employees, "conduct rules staff" (other than prescribed ancillary staff such as secretaries, IT and security staff etc). Further, the application of the conduct rules will not be limited to "accountable functions", as is currently the case for Approved Persons, but will apply to conduct in the performance of functions relating to the carrying on of activities (whether or not regulated activities) by the individual's employer.

The regulators will be able to take disciplinary action for a failure to comply with the new rules. Breaches of the conduct rules will be notifiable to the appropriate regulator and details would be appear in references.

## Statements of Responsibility and Management Responsibilities Map

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”.

A firm must have a comprehensive, up-to-date Management Responsibilities Map that describes its management and governance arrangements, indicating, for instance, the “prescribed responsibilities” allocated to those carrying on a SMF. This is to help the firm and regulators satisfy themselves that the firm has a clear organisational structure with no gaps in accountability; and to help the regulators to identify to whom it should speak to if something goes wrong.

## Presumption of responsibility

Under the SMR, the burden of proof is reversed, such that, in order to avoid a penalty, a senior manager who was responsible for the management of a firm's activities where there has been a regulatory contravention will 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”.

## New criminal offence

There is a new criminal offence of reckless decision-making causing an institution to fail. Attracting the moniker of the “Fred Goodwin offence”, it would apply where a person carrying on a SMF 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 might 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 suggested, would be difficult to prove, would be punishable by a term of imprisonment of up to seven years.

## UK branches of foreign banks

The SMR will apply in modified form to UK branches of foreign firms that accept deposits (or deal in investments as principal where a PRA-regulated activity) recognising that they are not legal entities separate from their overseas head offices. The regime will include a customised set of 12 prescribed responsibilities.

Like the APR, the SMR's application is greater for non-EEA than EEA firms reflecting the EEA home/host division of responsibilities. For non-EEA branches, the PRA will require at least one Head of Overseas Branch function, SMF 19. In the case of larger, more complex, branches with dedicated individuals performing executive SMFs (e.g. Chief Finance function, SMF 2) will also require approval. If other managers have direct decision-making responsibility over UK-regulated activities, they should be pre-approved as Group Entity Senior Manager of the branch, SMF 7. For its part, the FCA will approve certain SMFs. In contrast, for EEA firms, the only SMFs that apply are the FCA's SMFs for the Money Laundering Reporting function, SMF17 and the EEA Branch Senior Manager function, SMF 21. There are no PRA SMFs as prudential matters correspond to the home state.

In respect of certified persons, for non-EEA firms the SMR applies to individuals who are either based in or dealing (i.e. having contact) with a client in the UK, while for EEA firms only those individuals actually present in the UK are caught.

## Transitional arrangements

Where there is no substantive change of role, existing Approved Persons exercising SIFs will be subject to “grandfathering” over to an equivalent SMF role. For example, a Chief Risk Officer currently approved for the systems and controls (CF28) function would transfer to the related SMF4 Chief Risk function. A special procedure will apply where an application is pending under the APR at the commencement of the new regime. For what are called “in-flight applications”, firms will update the application specifying the SMF, providing a Statement of Responsibility and Management Responsibilities Map, together with a criminal records check.

Firms will have a period of 12 months from 7 March 2016 to issue certified persons with their first certificate of fitness and propriety under the new Certification Regime. All ordinary conduct rules staff will benefit from a 12 month transitional period to give firms time to properly train such individuals, the majority of whom will not previously have been subject to APER.

# UNDERSTANDING AND DELIVERING YOUR REQUIREMENTS

## How can AG support you?

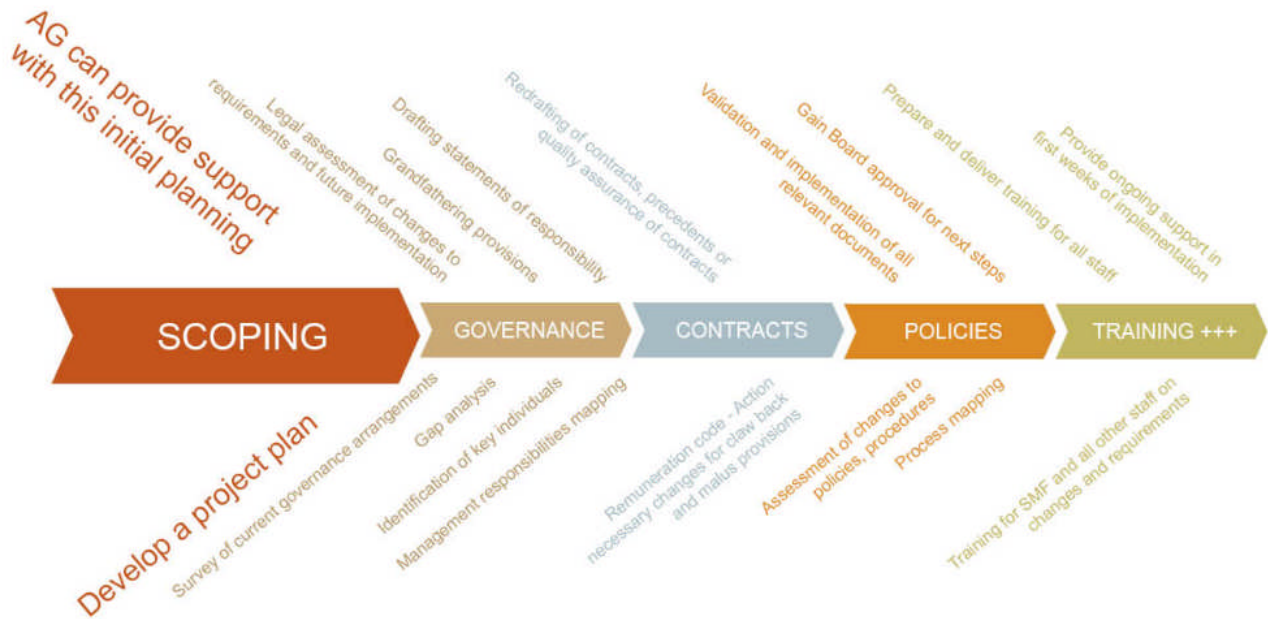
We are already working on a number of SMR implementation projects and are well placed to support you across the whole of your SMR implementation and roll-out project in a variety of ways, including:

- ▶ **Gap analysis:** helping you to survey your current arrangements and undertaking a gap analysis to determine the role of senior individuals under the new regime in order to identify those carrying on a SMF and to identify and complete a Management Responsibilities Map. We would also assist you in identifying those individuals subject to the Certification Regime;
- ▶ **Governance systems and controls:** assessing and putting in place appropriate governance systems and controls related to policies; regulatory reporting; training; assigning responsibility for the production of reports; and demonstrating to regulators that the systems and controls that are in place are robust and effective;
- ▶ **Statements of Responsibility:** drafting Statements of Responsibility for those carrying on a SMF, including aligning contracts of employment and having systems in place for responding to requests from the PRA / FCA for personal attestations from such individuals;
- ▶ **Risk aversion:** advising on mitigation of risk aversion by managers in the business. In these circumstances, it is important that senior managers are well advised as to their exposure and how to mitigate it; that the right training is put in place to support these individuals together with the right processes and, where required, initial, periodic and 'handover' reviews of governance and risk, as well as increased administrative support;
- ▶ **Employment law impact:** reviewing relevant HR policies such as referencing and disciplinary policies and procedures and, more particularly, considering the 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, suspension of employees, notification of disciplinaries to regulators, the handling of reference requests, record keeping, assisting with the drafting of a matrix to review individuals against the fit and proper test and advising on the position of contractors;
- ▶ **Regulatory notifications:** advising generally, where most employees will be personally liable for compliance with the Code of Conduct, there may be an increased incidence of notifications being required to regulators where firms "know or suspect" that there has been a breach of the Code. Similarly, there may be an increased incidence of employee whistle blowing;
- ▶ **Remuneration structures:** considering how the developing responsibilities interact with applicable Remuneration Code responsibilities and whether, for example, changes are needed to take account of clawback and malus provisions;
- ▶ **Bespoke training:** designing and/or delivering training for SMF holders (including the board) and certified persons on their respective regulatory obligations, including under the new Code of Conduct, as well as to equip the HR function on how best to support the business under the new regime; and
- ▶ **Grandfathering:** advising and providing assistance with respect to transitional provisions such as the "grandfathering" over of individuals currently approved to perform significant influence functions to an equivalent SMF role.

## Our approach

As an integrated financial services team, we have the advantage of being able to work closely across all of our relevant specialisms (including corporate (and corporate governance), financial services regulation (both contentious and non-contentious), employment and incentives) to deliver advice in a co-ordinated and seamless way that is in line with your requirements.

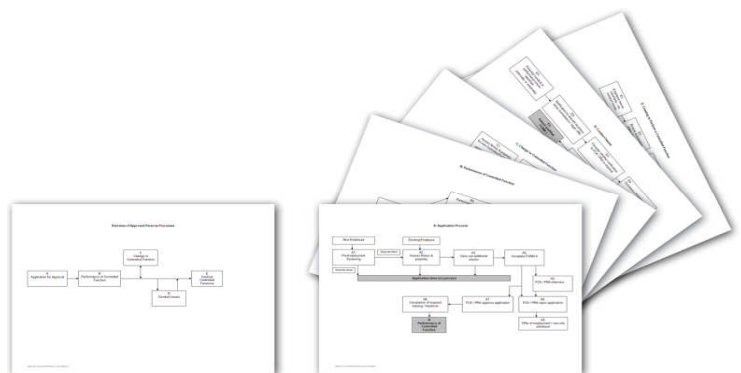
Based on our experience of managing regulatory change projects, we would work with you closely in developing the detailed project plan (including identifying key stages at which relevant stakeholder groups need to become more actively involved in the project). We would also assist you in prioritising specific work streams.



## Process Mapping

As a firm, we have significant experience of successfully designing and using bespoke 'process maps' on a range of other significant regulatory change projects for other financial institution clients.

By breaking down the key aspects of particular activities (for example, the 'lifetime' employment process from recruitment to termination), process maps can facilitate a more methodical and accessible approach and may assist in helping to distil and focus certain aspects of the your SMR implementation process. We would be happy to discuss this further with you if this would be of interest.



## How can Addleshaw Goddard help?

Addleshaw Goddard's Financial Regulation, Employment Law and Litigation specialists can advise you on managing and 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 of knowing 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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