

The UK's Senior Managers and Certification Regime

18 February 2019

1. Background

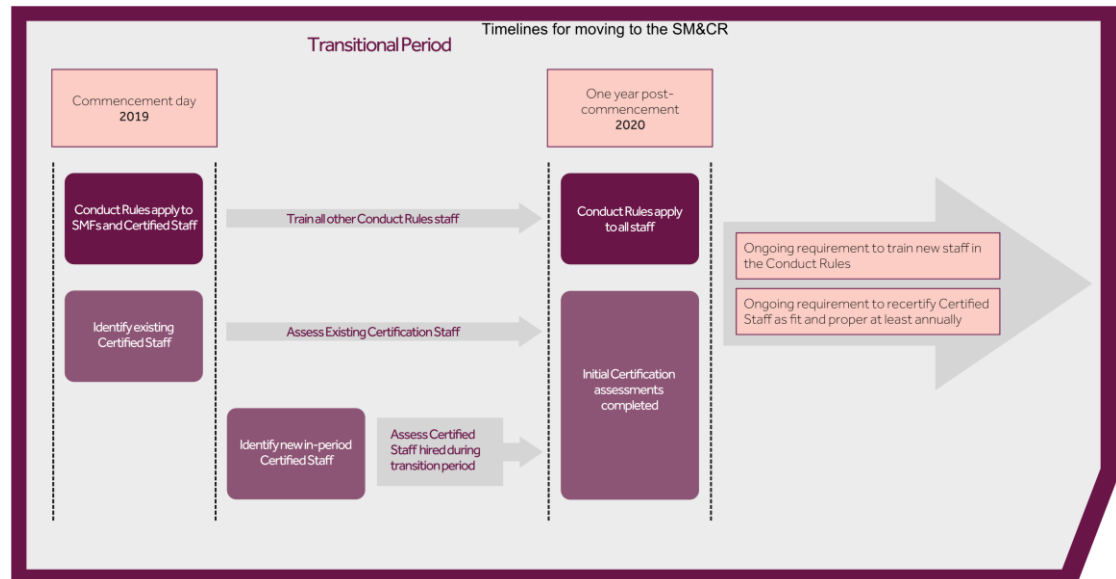
In 2016, the Senior Managers and Certification Regime (“SM&CR”) was introduced in the United Kingdom for banks, broker-dealers and insurers. The regime was designed to ensure better accountability of senior individuals for their decisions and conduct, requiring firms to allocate applicable responsibilities to relevant “Senior Managers”.

The clear objective was that each firm should identify an individual accountable for every aspect of its regulated activity, and for that individual to be liable if the regulator was subsequently able to show that the individual did not take “reasonable steps” to prevent misconduct within his or her area of responsibility. The regime also provides for firms to certify as “fit and proper” individuals who are not Senior Managers but who have responsibilities for functions with the potential to cause “significant harm.”

**Debevoise
& Plimpton**

Smaller firms were always intended to be covered by the SM&CR, and the Financial Conduct Authority (“FCA”) will now apply it to (almost) all FCA-authorized firms and branches of non-UK firms with permission to carry out regulated activities in the United Kingdom on 9 December 2019, although the “certification” and “conduct rules” elements of the regime will apply in stages.

As shown in the FCA’s graphic reproduced below, the new conduct rules will apply to Senior Managers and certified staff from 9 December 2019. In December 2020, conduct rules will apply to all staff. By December 2019, firms must have identified existing certified staff and by December 2020 firms must have completed their initial certification assessment.

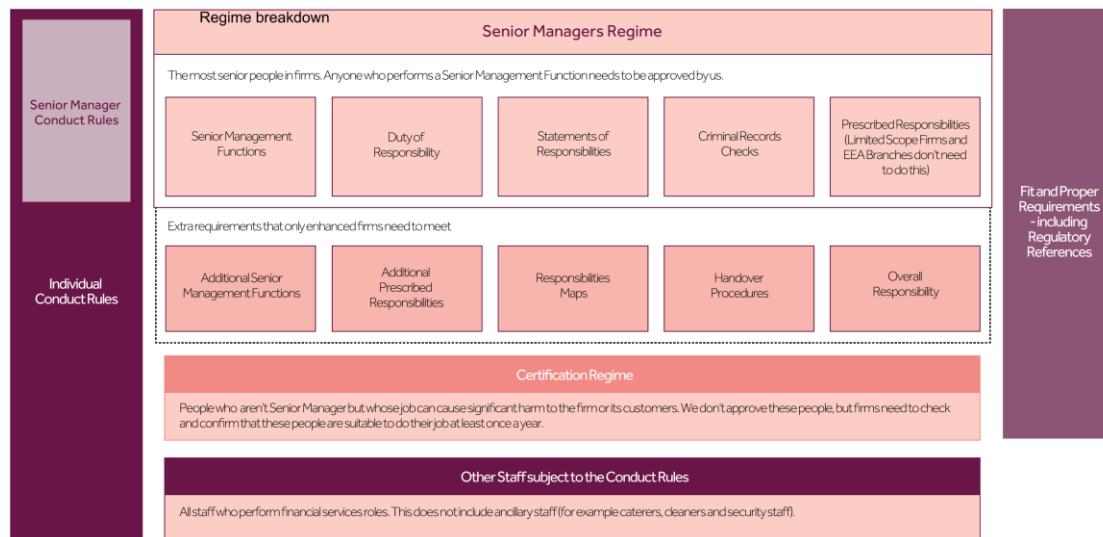


The regime divides FCA-authorized firms into three categories:

- **Core firms.** This category encompasses the majority of FCA regulated firms and is the focus of this note. It includes any firm that is not currently subject to a limited application of the Approved Persons regime, unless the firm meets one of the following criteria:
 - is a “significant IFPRU firm”;
 - is a “large CASS firm”;
 - has assets under management of £50bn or more (based on a rolling three-year average);
 - has annual intermediary regulated revenue of £35m or more (based on a rolling three-year average);
 - has annual revenue from regulated consumer credit of £100m or more (based on a rolling three-year average); or
 - is a mortgage lender with more than 10,000 mortgages outstanding.
- **Limited scope firms.** These are firms currently subject to limited application of the Approved Persons regime, including “limited permission consumer credit firms”, sole traders, insurance intermediaries whose principal business is not insurance intermediation and authorised internally managed alternative investment funds.

- **Enhanced firms.** This comprises all other firms.

Groups will need to implement the regime for each authorised entity within their group, whilst keeping in mind group governance arrangements.



2. Senior Managers Regime and Senior Management Functions

2.1 Senior Managers

The Senior Managers Regime applies to individuals in firms who perform a “Senior Management Function” (“Senior Managers”). This replaces the existing “Significant Influence Function” (which encompasses the Director function and CEO function).

A function is a “Senior Management Function” if: (a) the function will require the person performing it to be responsible for managing one or more aspects of an authorised person’s regulated activity, and (b) those aspects involve, or might involve, a risk of serious consequences for the authorised person, or for business or other interests in the United Kingdom.

The term “Senior Manager” covers a range of job titles and management arrangements, although any individual holding a title of chief executive, executive director or chairman will usually be a Senior Manager.

Under the regime, each Senior Manager will have a statement of responsibilities which will define exactly what the individual is accountable for. Each Senior Manager will need to be pre-approved by the FCA, although existing FCA Approved Persons will be grandfathered into the new regime where there is no change to the individual’s role.

The FCA can take enforcement action against the individual alone, either for failure by the individual to take “reasonable steps” to prevent misconduct by the firm or on the grounds of personal misconduct. The FCA can also act against the individual and firm together, such as where the senior individual has been responsible for failures in the firm’s systems.

2.2 Senior Management Functions

The regime establishes certain Senior Management Functions (“SMFs”) which apply to both core and limited scope firms. Most of these SMFs are currently “controlled functions” under the FCA’s Approved Persons regime.

Each Senior Manager will have a duty of responsibility for the responsibilities that are an essential part of the manager’s role and reflected by the SMF description. For instance, responsibility for regulatory capital will usually be allocated to the Chief Finance Officer. However, it will not always be the case that, for instance, money laundering compliance will be allocated to the existing money laundering reporting officer, who may not have sufficient authority or influence to be responsible.

Governing Functions

SMF1 (Chief Executive). This is the person with responsibility, under the authority of the governing body, for the conduct of the whole of the business (or relevant activities). Although the chief executive is the most senior member of an executive team, a firm’s governing body may also allocate specific responsibilities to other Senior Managers.

SMF3 (Executive Director). A director of a firm, other than a non-executive director.

SMF27 (Partner). A partner in a firm (usually a limited liability partnership). The starting point for identifying Senior Managers in a partnership will be those partners who form the executive or governance committee, if any, or those partners with “corporate office” designations. If a partner who is a Senior Manager performs another Senior Management function—such as Chief Executive or Compliance Oversight (see below)—he or she will need to be approved for both roles. Partners who do not manage the firm may not be Senior Managers. If junior partners who are currently approved by the FCA (under CF4 – Partner Function) do not meet the criteria to be a Senior Manager, the firm will need to submit a Form C to cancel that individual’s approval.

Governing Function: Non-Executive

SMF9 (Chair). This is the person responsible for chairing and overseeing the performance of the governing body of the firm. Firms will need to consider whether any individual with the title of chairman should step into the regime. Non-Executive

Directors at core and limited scope firms who are not the firm's Chair will no longer need to be approved by the FCA.

Required Functions

SMF16 (Compliance oversight). This is the person responsible for, and who reports to the governing body on, the compliance function. Firms will need to consider whether the current holder of the compliance oversight function (CF10) is sufficiently senior to be part of the regime.

SMF17 (Money laundering reporting officer (MLRO)). This is the person responsible for overseeing the firm's compliance with the FCA's rules on systems and controls against money laundering.

SMF29 (Limited scope function). This is relevant to limited scope firms only.

As is the case under the existing Approved Persons regime, firms are not required to name an individual to each of the above SMFs. For example, firms that do not have a person filling the role of "Chair" will not need to create this function under the new rules.

Because previously approved individuals will be grandfathered into the new regime if there is no change to the individual's role, the FCA will automatically convert most of the Approved Persons at core and limited scope firms into the corresponding new SMFs, with no action required by firms. For core firms, if someone is currently approved by the FCA and the equivalent role exists in the new regime, they do not need to apply for reapproval. Enhanced firms, however, will need to submit a conversion notification (Form K).

This table sets out the corresponding SMFs for core firms.

Current Controlled Function	Possible Corresponding SMF(s)
CF1 (Director)	SMF3 (Executive director)
CF2 (NED)	SMF9 (Chair)
CF3 (Chief executive)	SMF1 (Chief executive) SMF19 (Head of third country branch)
CF4 (Partner)	SMF3 (Executive director) SMF27 (Partner)
CF10 (Compliance oversight)	SMF16 (Compliance oversight)
CF11 (MLRO)	SMF17 (MLRO)
CF29 (SMF)	SMF21 (EEA branch SMF)

In January 2019, the FCA concluded that the position of head of legal was excluded from the requirement to be approved as a Senior Manager, primarily on the grounds that legal privilege would restrict the manager from demonstrating that he or she took reasonable steps to avoid a contravention of a regulatory requirement.

Individuals who are approved under the Approved Persons Regime and who will not be designated Senior Managers should cancel their approval (Form C) before the start of the new regime.

An individual can hold more than one SMF. In such a case, a single statement of responsibilities covering all SMFs held by that person can suffice.

2.3 Management Responsibilities Statement and Map

An enhanced firm must maintain a document that describes its management and governance arrangements, including (i) details of reporting lines and lines of responsibility; and (ii) details about the persons in these arrangements and their responsibilities, including how these responsibilities are shared or divided between different persons. The FCA has noted that all firms may find it helpful to refer to the principles and guidelines of the Responsibilities Map, even though it is not compulsory for a core firm.

2.4 Prescribed Responsibilities

Core firms must also allocate the following “prescribed responsibilities” to Senior Managers. In practice, firms are likely to allocate the prescribed responsibilities to one or two individuals, typically the CEO and the head of compliance.

- Performance by the firm of its obligations under the Senior Managers' Regime, including implementation and oversight.
- Performance by the firm of its obligations under the certification regime.
- Performance by the firm of its obligations in respect of notifications and training under the conduct rules.
- Responsibility for the firm's policies and procedures for countering the risk that the firm might be used to further financial crime. This encompasses money laundering, sanctions, fraud, tax evasion and cybercrime.
- Responsibility for the firm's compliance with the Client Assets sourcebook (CASS). This is only applicable to firms with authority to hold client money or client assets.
- Responsibility for an asset management firm's value for money assessments, independent director representation and acting in investors' best interests. This is only applicable to managers of authorised (retail) funds.

The FCA does not expect all prescribed responsibilities to be allocated to the head of compliance, if only because doing so undermines compliance's role as an independent "second line of defence" for risk or compliance failings. For core firms that have few Senior Managers, one approach would be to allocate the more governance-oriented responsibilities to the chief executive and more compliance-oriented responsibilities to the head of compliance.

Changes to allocations of prescribed responsibilities do not require reapproval of an individual by the FCA.

2.5 Sharing Responsibilities

Responsibilities will generally be allocated to one individual. The FCA has indicated that there are only limited permissible circumstances for sharing or dividing a responsibility, such as in the context of a job-sharing arrangement or where departing and incoming Senior Managers work together temporarily as part of a transition. In any such case, each Senior Manager is jointly accountable and the firm must confirm that there are no gaps in the allocation of responsibilities as a result.

Partnerships have more discretion to share or divide responsibilities. A responsibility or function can be shared between several partners or with more senior partners having more responsibilities than a junior partner. Firms should detail these arrangements in each partner's Statement of Responsibilities. However, the FCA has stated that, unless

there is a strong justification, *prescribed* responsibilities should not be divided or shared between partners.

2.6 Territoriality

The regime applies to FCA-authorized firms, in respect of their business inside or outside the UK. Firms must allocate responsibility to a Senior Manager for all activities, business areas and management functions of the firm, including those carried out from a branch overseas.

Because the regime applies to legal entities individually, rather than to a group as a whole, there is a limit to which the regime can apply to individuals in a firm's parent or group entities, particularly those based overseas. There are different views on whether an individual based outside the UK is within the regime—firms may be unwilling to hold an overseas individual directly accountable to the FCA for supervision of the firm's activities, even where that individual holds, for instance, veto power over key management decisions to be taken by the UK firm. In addition, firms will need to consider the position of the directors of an entity that acts as the corporate "managing member" of an LLP.

2.7 "Duty of Responsibility" Replaces "Presumption of Responsibility"

The original legislation included a presumption of responsibility (the "reverse burden of proof"). In other words, if a firm contravened a regulatory requirement, the Senior Manager responsible for the activity in question was presumed guilty of misconduct. The only permissible defence was for the person in question to satisfy the regulator that he or she took such steps to prevent the misconduct as a person in their position could reasonably have been expected to take.

The presumption of responsibility has been replaced with a statutory *duty* of responsibility. This ensures that the FCA can take action if it can show that the individual failed to take steps that are reasonable for a person in that position to take to prevent a regulatory breach from occurring. The FCA will need to demonstrate how the Senior Manager failed to take such steps, rather than requiring the Senior Manager to explain why his or her steps were reasonable.

The FCA's guidance indicates that, in deciding whether reasonable steps were taken, relevant considerations will include: whether the individual was aware or should have been aware of possible breaches by the firm of regulatory requirements; whether any delegation was reasonable and overseen; whether reporting lines were clear; whether the individual informed himself about the firm's activities; and, where the decision was a collective decision, whether the individual took care in contributing to the decision. In practice, managers should consider the following:

- Firm governance must provide the Senior Manager with the necessary authority, access, information and resources to properly discharge his or her responsibility.
- Delegation procedures will need to be detailed.
- Managers may want key decisions to be recorded in the context of a committee decision, not on the basis of one-to-one discussions.
- A checklist should be established for the review of systems and controls.

Senior managers might also want to check to see that they are adequately covered by D&O indemnity insurance, which may not cover all Senior Managers under the regime.

2.8 Steps to Take

Firms should take these key steps:

- Identify all entities (UK-regulated firms) that are covered by the regime.
- Consider the activities, business areas or functions performed by each entity and the relevant prescribed responsibilities.
- Identify the individuals who hold SMFs.
- Allocate the prescribed responsibilities to at least one SMF.
- For each entity, identify any other individual that has overall responsibility for any other activity, function or business area.
- Record the allocation of responsibilities on individual Statements of Responsibilities.
- Consider changing reporting lines, committees and decision makers to ensure that the Senior Manager has the right delegates.
- Involve the HR team in the process, in terms of policies, record-keeping (including HR files on individuals) and ensuring that disciplinary processes and appraisals should form part of the certification process (see below).

Under the regime, each Senior Manager signs a Statement of Responsibilities to ensure that he or she clearly understands his or her responsibilities, using a template which must be submitted to the FCA and resubmitted when there is a change in the Senior Manager's responsibility. Whilst the Statement of Responsibilities does not imply that

an individual performs all the tasks or knows everything within the affairs listed in his or her areas of responsibility, it implies that the individual is responsible for oversight of those activities, including for any areas (such as fund administration) that may be outsourced by the firm.

Firms should also consider changes to employment contracts. Employment contracts may need to be redrafted (or accompanied by a side letter) to refer to the regime and to ensure that job descriptions in contracts fit with the individual's Statement of Responsibilities. It may be helpful to contractually bind staff to follow the conduct rules (see below) and to perform responsibilities outlined in their Statement of Responsibilities. For existing employment agreements, it may be more practical to make changes to the contracts of new joiners or on job renewal. It will be helpful to include provisions in contracts requiring the individual to co-operate with future changes in the Responsibilities Map and on handover of their role.

When a Senior Manager leaves, transition arrangements will be crucial—particularly if a Senior Manager leaves without notice. A firm will need to consider how it can check whether a Senior Manager discharged his responsibility before he or she leaves, and may find it helpful to have standard questionnaires for incoming and outgoing persons. After a grace period, it is likely that legacy issues will become the responsibility of the incoming Senior Manager.

3. Certification Regime

3.1 Overview

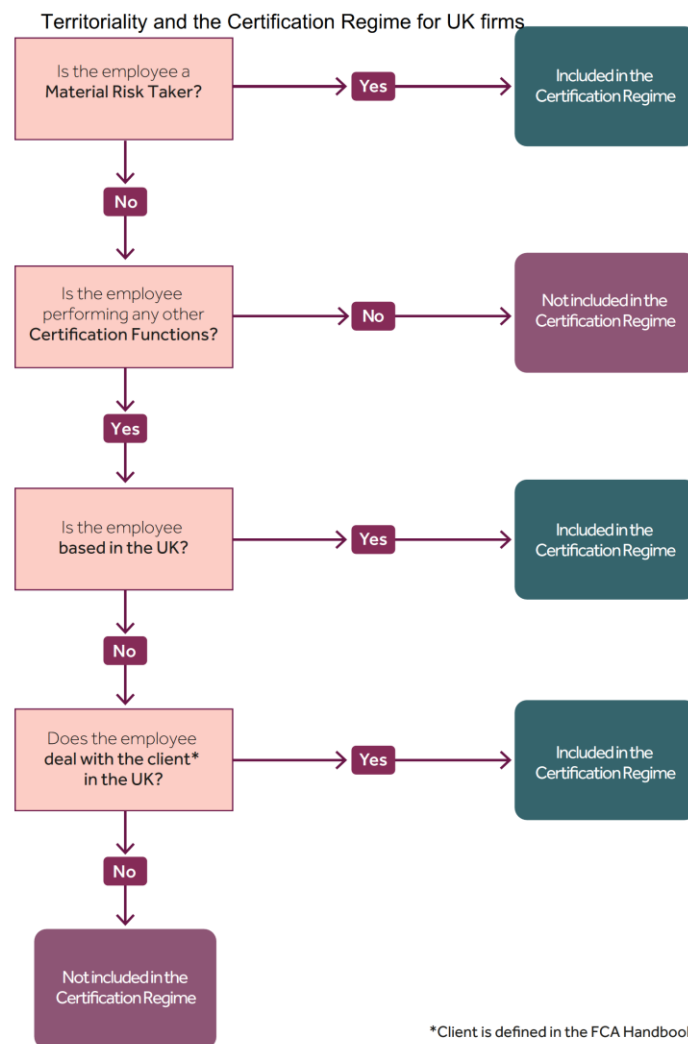
The certification regime replaces the Approved Persons regime. The Approved Persons regime was perceived as ineffective because it covered a too-narrow set of individuals and did not require firms to take responsibility for fitness and propriety of their staff.

Under the new regime, the Financial Services Register, which currently lists FCA Approved Persons, will only include Senior Managers. Certified staff and other “suitable individuals” (directors, sole traders and appointed representatives who need to show they are suitable, competent or fit and proper either to the FCA or their firms under other requirements) will be listed in a new FCA directory of “Directory Persons.”

Under the certification regime, the firm must certify an individual who is to perform an FCA-specified “certification” (or “significant harm”) function. This is a function that meets the following conditions:

- it requires the person performing it to be involved in one or more aspects of the relevant authorised firm’s affairs, so far as relating to the activity; and
- those aspects involve, or might involve, a risk of significant harm to the relevant authorised firm or to anyone who is using, or who is or may be contemplating using, any of the services provided by the relevant authorised firm.

Firms must ensure that employees are certified if they are based in the UK (or spend more than 30 days a year in the UK) or deal with UK customers.



The firm must be satisfied that the person is a fit and proper person to perform the FCA-specified significant-harm function to which the certificate applies. This includes

having the necessary qualifications and training, the requisite level of competence and the personal characteristics required by the FCA's rules.

If a person performs more than one certification function, a firm will need to certify that the person is fit and proper to carry out each function. If a Senior Manager performs a certification function that is closely linked to their role as a Senior Manager, they will not need to be certified. If, however, they are performing a certification function different from their Senior Manager responsibilities, they will need to be separately certified for that function. This is not expected to be common in practice.

The FCA has confirmed that the certification regime will not apply to partners, because partners do not meet the definition of "employee" under the Financial Services and Markets Act. However, firms may, as a matter of best practice, choose to apply the certification regime to partners.

Core Firms

The FCA will make the following roles certification functions:

- **Significant management function (current CF29).** The significant management certification function applies to someone with "significant responsibility for a significant business unit". This covers people below Senior Managers who are responsible for significant business units in the firm.
- **Proprietary traders (current CF29).**
- **CASS oversight function (current CF10a).** These individuals perform functions that would have been significant influence functions (SIF) under the Approved Persons regime.
- **Functions subject to qualification requirements.** This includes, for example, mortgage advisers, retail investment advisers and pension transfer specialists.
- **Client-dealing function.** This function will be expanded from the current CF30 function to apply to any person "dealing with" clients, which means having contact with clients (other than in a purely administrative sense). This will cover people who:
 - advise on investments (other than a non-investment insurance contract) and perform other related functions, such as dealing and arranging deals;
 - act as an investment manager and other functions connected with that role;

- act as a bidder's representative; or
- supervise or manage a certified function (directly or indirectly) unless they are a Senior Manager. This will ensure that people who supervise certified employees are held to the same standard of accountability. It also ensures a clear line of accountability between junior certified employees and the Senior Manager ultimately responsible for that area.

It is likely that senior investor relations individuals are within the client-dealing function, but it is not clear if this is true of junior investment professionals, who may not be responsible for investment recommendations.

- **Material risk-takers.** The concept of material risk-takers (also known as remuneration code staff) already exists for firms under the FCA's remuneration rules, but they are not currently controlled functions. Instead, they are a category of staff that relevant firms are required to identify under the FCA's remuneration regime. It appears that an "Exempt CAD" firm which is not subject to remuneration rules and has no material risk-takers will not be required to identify any material risk-takers, despite having individuals remunerated at a level which might otherwise cause them to fall within that definition.
- **Algorithmic trading.** This function includes people with responsibility for approving the use of a trading algorithm.

The certification regime will not apply to appointed representatives, which will continue to be in the Approved Persons regime.

3.2 Territorial Scope

A function is a significant harm function if:

- it is performed by a person from an establishment of the firm (or appointed representative) in the UK; or
- the person performing that function is dealing with (meaning having contact with) a client of the firm in the UK from an establishment of the firm (or appointed representative) overseas.

There is an exemption for individuals who spend no more than 30 days a year in the UK. However, if an individual is a material risk-taker under one of the remuneration codes, the certification regime will apply even if they are based overseas and do not deal with a UK client.

3.3 Fitness and Propriety Test

Firms will need to decide the best way of certifying individuals and do not need to adopt the same criteria for fitness and propriety for all roles and levels of seniority.

The certificate must state that the firm is satisfied that the person is fit and proper to perform the function to which the certificate applies. The certificate is valid for 12 months. It will apply at recruitment and on an ongoing annual basis—usually coinciding with an individual's appraisal. If an individual's role changes, a firm may have to certify that the individual is fit and proper to perform that function before they start.

In certifying fitness and propriety, a firm should:

- follow existing FCA high-level principles;
- apply the same factors that the FCA considers when assessing fitness and propriety (honesty, integrity and reputation; competence and capability; and financial soundness);
- conduct criminal record checks. While background checks are only required for Senior Managers, firms may employ these checks for other individuals; and
- obtain a regulatory reference (see below) from all previous employers for the last six years.

Practical guidelines for conducting a fit and proper assessment include:

- The assessment will typically be made by an individual's direct line manager or the compliance head.
- On recruitment, firms can rely on a range of sources and tools, including through interview questions, a review of qualifications and training and regulatory references.
- For annual certification, firms can rely on self-declarations, ongoing professional association memberships and the individual's performance and attendance at firm training.
- Firms may conduct screening (such as criminal records and insolvency checks) for individuals upon appointment and then screen a sample of staff each year.

- Firms will need to adapt their internal disciplinary process so it includes the fit and proper test.
- Firms may need to establish a “fit and proper” committee to adjudicate cases of breaches of conduct rules and whether such a breach warrants a loss of certification or internal sanction.
- If a firm does not certify a person as fit and proper, or revokes the certification, because of a conduct rule breach, the firm should notify the FCA.

3.4 Regulatory References

Key issues involving regulatory reference include:

- The reference will need to disclose any facts that led an employer to conclude that an individual breached a conduct rule and a description of the basis and outcome of the disciplinary action.
- Firms will need to update references given in the last six years, when they become aware of matters that would cause them to draft the reference differently.
- An employee might ask to agree the contents of a reference. Ordinarily, a firm should not agree to do this, as it would conflict with the firm’s regulatory duties.
- Firms must give yes or no answers to certain questions in the reference. If an individual leaves midway through an investigation into their conduct, it may be challenging for a firm to give these answers.
- Firms must respond to requests for regulatory references.

4. Conduct Rules

4.1 Overview

The new FCA conduct rules replace the Code of Practice for Approved Persons. Firms will need to update their existing codes of conduct.

The rules will apply to:

- Senior Managers;

- all non-executive directors who are not Senior Managers;
- individuals covered by certification regime; and
- all other employees other than ancillary staff (those who perform a role that is not specific to the financial services business).

Conduct rules are high-level and reflect the core standards expected of staff who work in covered firms. They are:

- You must act with integrity.
- You must act with due skill, care and diligence.
- You must be open and co-operative with the FCA and PRA.
- You must pay due regard to the interests of customers and treat them fairly.
- You must observe proper standards of market conduct.

Senior Managers have additional conduct rules, such as taking reasonable steps to ensure that any delegation of responsibilities is made to an appropriate person and that the individual oversees the discharge of the delegated responsibility effectively. A Senior Manager will need sufficient evidence to rebut a presumption that he or she did not oversee the delegation properly.

Firms must inform each certified person of his or her responsibilities—tailored to his or her role. This includes appropriate training, and should be reflected in the appraisal. Training should be sufficiently tailored.

Firms are now accountable to the regulator for the conduct of their employees, because they must notify the regulator of any breach of the conduct rules. Not every internal disciplinary matter might involve a breach of the conduct rules—there might be a higher threshold for a breach of a conduct rule. The distinction is important, because every regulatory reference must include details of any breach of the conduct rules.

* * *

Please do not hesitate to contact us with any questions.

CONTACTS



Patricia Volhard
pvolhard@debevoise.com



Karolos Seeger
kseeger@debevoise.com



Simon Witney
switney@debevoise.com



John Young
jyoung@debevoise.com



Jin-Hyuk Jang
jhjang@debevoise.com



Gabriel Cooper-Winnick
gcooperwinnick@debevoise.com



Christopher Garrett
cgarrett@debevoise.com



Andrew Lee
ahwlee@debevoise.com



Eric Olmesdahl
eolmesdahl@debevoise.com



Philip Orange
porange@debevoise.com



Johanna Waber
jwaber@debevoise.com



Clarisse Hannotin
channotin@debevoise.com