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Extension of the SMCR – filling in the blanks

The long-awaited consultation paper on rolling out the Senior Managers and Certification Regime to all regulated financial services firms, has not dispelled a number of practical difficulties for smaller entities that are faced with its imminent implementation. They should make the most of the unfinalised timeline to submit feedback to the regulator as well as plan ahead, advises Julian Sampson.

The publication in July just past of the Financial Conduct Authority's proposals for the extension of the Senior Managers Regime marks the opening shots in what promises to be a protracted implementation.

CP17-25 'Individual Accountability: Extending the Senior Managers & Certification Regime to all FCA firms' sets out the FCA's initial proposals, with a response date in November 2017 and no further specifics as to the dates of further consultation papers on templates and processes, let alone a proposed date for actual implementation. Nothing more specific than sometime in 2018.

While the lack of any more detailed timetable might be frustrating, firms would be well advised to use this breathing space (and rest breaks from their MiFID II implementation) to consider how best they should apply this proposed new regime.

Make no mistake – this extension is probably more important to the FCA than MiFID II. At its annual meeting in July, FCA chairman John Griffith-Jones described SMCR as possibly "the most single significant issue that we have dealt with in the last four years" since it had been founded. And that will doubtless feed through into the regulator's enforcement priorities as well.

The key components of the regime will be familiar to readers of *Compliance Monitor* (see our previous article 'Applying the SMCR to out-of-scope firms' of November 2016). They consist of the Senior Managers Regime, under which the FCA will approve the most senior appointments in a firm, the Certification Regime, where the firm will be responsible for all applicable due diligence on an employee who will not be approved by the FCA, and a new set of Conduct Rules covering all but ancillary staff.

The most important thing to note is that the FCA has tried to live up to its pre-publicity by stratifying the proposed regime on a proportionate basis. Different rules apply to different firms, depending on whether they are 'Enhanced', 'Core' or 'Limited Scope'. The FCA has proposed criteria for assessing into which tier a firm falls, and for moving between tiers. It expects only 350 firms to meet the Enhanced criteria, leaving the bulk of the 47,000 remaining firms in the other categories.

Although this is welcome, the criteria that the FCA has proposed for inclusion in the lighter-touch Limited Scope are limited to those firms currently subject to a limited application of the Approved Persons Regime. It would have been helpful for this to have been extended to include in Limited Scope some reference to firms that either have no retail clients, are restricted in their permissions to corporate finance business, or have fewer than ten members of staff or approved persons. In that way the FCA would better be able to focus its resource where it is most effective.

In its proposals for the Senior Managers Regime, the FCA follows a path set out by the March 2016 implementation in the banking and insurance sectors. The most senior members of staff at firms (generally, directors) will need to be pre-approved by the FCA and

to hold a 'Statement of Responsibilities'. These will need to be kept up to date and forwarded to the FCA when there is a major change. The regulator will release the template for this Statement in a later consultation. Much of the implementation headache will depend on the complexity of the template.

The FCA also lists a number of "prescribed responsibilities" which must be allocated among the Senior Managers. Again, these follow a familiar course, but firms should keep an eye on the proposed responsibility for "ensuring the governing body is informed of its legal and regulatory obligations". Unless the firm is lucky enough to employ a General Counsel, it is not obvious to whom this responsibility should fall, especially given that most firms in the Core and Limited Scope tiers will rely on external advice in this area. Firms would be well advised not to allocate this to the Compliance Officer, whose knowledge base is likely to represent only a sub-set of the firm's legal and regulatory obligations.

Similarly, responsibility for "performance by the firm of its obligations in respect of notifications and training of the Conduct Rules" requires careful thought. The training obligations themselves sound uncontroversial – firms should "make individuals who are subject to the Conduct Rules aware that this is the case, and train them in how the rules apply to them." But this may not be as simple as it sounds. The Conduct Rules are couched in the most general of terms, similar to the Principles for Approved Persons. It's not enough to tell staff what the Conduct Rules are – firms must "ensure that their staff understand what the rules mean to them in the context of their particular firm". This will probably require bespoke training tailored to the requirements of the firm and the job holder – and that's neither easy nor cheap.

All of this is important because of the new 'Duty of Responsibility' placed on Senior Managers. As the FCA says, this "means if something goes wrong in an area that they are responsible for, we will consider whether they took 'reasonable steps' to stop this from happening." If the FCA believes that reasonable steps were not taken, enforcement proceedings will follow. And the evidence that they will look at is what their Statement of Responsibilities says they are responsible for and what training they have had.

It follows from the forgoing that the greater part of a firm's pre-implementation project should be spent assessing the evidence the firm has to support that senior manager's 'reasonable steps'.

As with the Senior Managers Regime, the Certification Regime follows a well-worn path. Those employees whose roles "involve, or might involve, a risk of significant harm to the firm or any of its customers" are not to be approved by the FCA, but are to be subject to what the regulator believes is the more forensic and acute due diligence of the firm. Those subject to this regime include (and are not limited to) all those who deal for a customer or require a qualification for their role and their managers.

The due diligence required includes the regulatory reference. The FCA makes no observations as to what the firm should do when the referee is no longer trading or decides for whatever reason not to respond to the request. The requirement to update historic references for new information is likely to prove as onerous and contentious for firms new to this regime as it was to the banks and insurers.

The FCA proposes that criminal records checks be mandatory for applicants for Senior Manager roles. The advantage that this gives, the FCA believes, is that it "will ensure the information the candidate has given to the firm is accurate and complete". There is no evidence cited by the FCA to support their implicit contention that candidates were lying to firms about their criminal past, or that firms' normal (and now enhanced) due diligence procedures would otherwise be incapable of detecting a spell inside. Given that candidates for senior management roles at Core and Limited Scope firms are usually known to existing management, or at least subject to adequate due diligence, this requirement would seem unnecessary.

Firms' appraisal systems will certainly require a re-boot as a result of the proposals in CP17-25. Most of the requirements of the new regime are to be reviewed by the firm on at least an annual basis. At the conclusion of this assessment, the firm is required to issue the employee with a 'certificate'. The FCA clearly believes that having a certificate is an axiomatic part of the 'Certification Regime' – although what the purpose of such a certificate is and who it is meant to benefit are not stated. Clearly such a certificate cannot be used as part of a referencing procedure. And it doesn't tell any participant in the process – either the employee or employer – anything they don't already know. The FCA would be well advised to withdraw this requirement from Core and Limited Scope firms during consultation.

As we've discussed, the Conduct Regime is one of the key planks of the changes. The FCA has high hopes for the new conduct rules – "they represent a meaningful change in the standards of conduct we expect from those working in the industry" it says, in two separate places. But it's hard to see how rules that look almost identical to the existing APER principles can represent such a sea-change.

The Conduct Rules are to apply to all but ancillary staff, and the FCA gives a list of 20 roles, ranging from receptionists to Human Resources processors, which it deems to be ancillary. Interestingly, the regulator states that this list is "exhaustive". There can be no other roles at firms that might be ancillary. This seems a bold statement, and firms will want to consider whether they have staff members carrying out what they consider to be ancillary roles that are not mentioned in the FCA's list, and input to the consultation process accordingly.

Hanging off the back of the Conduct Regime is a requirement to notify the FCA of any conduct rule

breaches. When these concern a Senior Manager, the FCA wants to be told about these breaches "within seven business days of the firm becoming aware of the matter". What the FCA means by "becoming aware" is unclear. It would be prejudicial to the individual, and potentially misleading to the FCA, were the firm to be required to notify the regulator of any unsubstantiated allegation made. When it comes to other staff, the FCA wants to be told about any breaches on an annual basis. This seems unnecessary given that most will be nil returns – hopefully the FCA will relent and let this be notification on an exception basis.

Yet on a wider level, these proposals, and the initial implementation before them, represent another nail in the coffin of the Board of Directors. The FCA piously intones that "the ultimate decision-making body of a firm is its governing body, acting collectively. Individual accountability under the SM&CR does not cut across or undermine this." This cannot be correct, given the premium placed on individual responsibility and accountability by the SMCR regime as opposed to the responsibility of the Board. The SMCR entrenches a conflict of interest between the individual Senior Manager and the Board as a whole. The downside risk faced by the individual Senior Manager is now far in excess of that faced by the Board collectively. It is not in the interest of the Senior Manager to allow the Board to have significant input into decisions for which they bear personal responsibility. As a consequence, there is a risk that the quality of Board discussion and debate will decline as individual Senior Managers look to protect themselves from regulatory attack by making sure that at least they fulfill the terms of their Statement of Responsibilities by taking full – and undiluted – responsibility for their decisions.

So there's plenty to ponder. Firms will certainly want to start thinking about how they might implement the regime, starting with whom they have available to take up senior management roles and how they might document their responsibilities. Job descriptions will be key until the templates come out. Further consultations are due, and there will be changes before these rules become final. Watch this space.

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