



HM Treasury

Senior Managers and Certification Regime:

extension to all FSMA
authorised persons

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1 Introduction

1.1 The government is proposing to extend the Senior Managers and Certification (SM&CR) regime to all sectors of the financial services industry, replacing the discredited Approved Persons Regime. The key features of the extended SM&CR are:

- an approval regime focused on senior management, with requirements on firms to submit robust documentation on the scope of these individuals' responsibilities
- a statutory requirement for senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility
- a requirement on firms to certify as fit and proper any individual who performs a function that could cause significant harm to the firm or its customers, both on recruitment and annually thereafter
- a power for the regulators to apply enforceable Rules of Conduct to any individual who can impact their respective statutory objectives

1.2 This expansion of the SM&CR to all financial services firms will enhance personal responsibility for senior managers as well as providing a more effective and proportionate means to raise standards of conduct of key staff more broadly, supported by robust enforcement powers for the regulators.

1.3 The application of the SM&CR to the whole financial services industry also brings in a stronger, comprehensive regime across banking and other financial services. It enables the effective and efficient regulation of groups with a variety of financial services firms within them. It supports a level playing field for competition. It removes opportunities for regulatory arbitrage; for instance, by ensuring that the same high standards apply in both the banking and the so-called 'shadow banking' sectors.

Background

1.4 The financial crisis in 2007-08 and more recent events have highlighted concerns about the performance and behaviour of many of the individuals working in the financial services industry. Following its reforms to the regulatory system in the Financial Services Act 2012, the government brought forward reforms to the way individuals who work in banking¹ are regulated through a series of amendments to the Financial Services and Markets Act 2000 (FSMA) which were included in the Financial Services (Banking Reform) Act 2013. These amendments provided the legislative framework to implement the recommendations of the Parliamentary Commission on Banking Standards (PCBS) in relation to individual conduct and standards in banking.²

1.5 The main way individuals who work in the financial services industry have been regulated is through the Approved Persons Regime (APR) in Part 5 of FSMA. Under the APR, financial services firms ("authorised persons" under FSMA) may not employ a person to perform a "controlled function",³ unless that person has been approved by the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA) following an application by the firm concerned.

¹ In this context, "banking" means the activities of banks, building societies, credit unions (collectively known as "deposit takers") and certain investment firms that are regulated by the PRA for prudential purposes (as well as by the FCA for conduct of business purposes) (known as "PRA-regulated investment firms") and includes UK branches of corresponding foreign institutions.

² See the PCBS final report *Changing banking for good* (HL Paper 27, HC 175, published 19 June 2013) and the government's response (Cm 866, published 8 July 2013).

³ The controlled functions are specified in rules made by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).

Approved persons must comply with the statements of principle which are a series of binding standards of professional conduct issued by the FCA and PRA. The regulators may take enforcement action against approved persons for breaches of the statements of principle. They may also take enforcement action against approved persons for being knowingly concerned in a breach of regulatory requirements by the firm.

1.6 The PCBS was very critical of the APR. At the time of its report, the PCBS took the view that the APR was too broad and insufficiently focused on senior management. It concluded that:

- the APR acted mainly as an initial gateway rather than as a system for the effective ongoing supervision of the most important individuals in firms
- there was a lack of clarity of the responsibilities of individuals at senior level
- institutions did not take enough responsibility for the fitness and propriety of their own staff at more junior levels
- there were gaps in the regulators' enforcement powers

1.7 The PCBS expected that the deficiencies it had identified in the APR and its operation were unlikely to be confined to banking. However, they were concerned that attempting to extend the reforms they proposed to all sectors would delay the timetable for implementation for banks. They recommended, therefore, that the reforms should initially be introduced only for banking. The government shared those concerns and therefore prioritised the implementation of the regime for the banking sector.

1.8 Following Royal Assent to the Financial Services (Banking Reform) Act 2013 in December 2013, the PRA and FCA have been developing detailed implementing measures, including rules and guidance, for the SM&CR for banking, while the Treasury prepared the secondary legislation needed to ensure a smooth transition to the SM&CR from the APR. The Treasury also consulted on extending the SM&CR to UK branches of foreign banks. The Economic Secretary to the Treasury announced in a Written Ministerial Statement to Parliament on 3 March 2015 that the SM&CR would come into operation on 7 March 2016.⁴

1.9 In June 2014, the Chancellor of the Exchequer established the Fair and Effective Markets Review (FEMR) to conduct a review of the way wholesale financial markets operate, to help restore trust in those markets in the wake of a number of recent high profile abuses. The Review published its final report on 10 June 2015.⁵ Among other recommendations, the Review recommended that elements of the SM&CR should be extended to cover firms active in fixed income, commodity and currency (FICC) markets. Former members of the PCBS also called for the SM&CR to be extended to the rest of the financial services industry outside banking.⁶ This call has been echoed by the Treasury Select Committee on occasions.

1.10 The PRA is also introducing a Senior Insurance Managers Regime (SIMR) for insurance firms. For firms subject to the requirements of the EU Solvency II Directive,⁷ the SIMR includes rules implementing a number of requirements relating to the fitness and propriety of individuals performing senior and/or operationally important roles in insurance firms. Although the SIMR relies on the same legal framework as the APR, it incorporates some of the concepts used in the SM&CR where appropriate and possible.

⁴ Hansard 3 March 2015, Column 47WS.

⁵ Available on the Bank of England website (<http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx>).

⁶ See the *Statement by former Members of the PCBS* published 4 November 2014.

⁷ Directive 2009/138/EC of The European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) (recast).

1.11 The government considers that it is now appropriate to extend the SM&CR more widely, creating a more rigorous, comprehensive and consistent approach across the financial services industry. Many firms beyond the banking sector – such as large investment firms, insurers and those involved in shadow banking – can pose a threat to financial stability. Misconduct by firms of any size can have serious impact on the welfare of consumers or on market integrity, which will in turn harm consumers, investors and the businesses that depend on fair and effective markets. Such misconduct can be caused by similar failings to those identified by the PCBS in banks. The government has decided, therefore, to extend the SM&CR to all sectors of the financial services industry, including insurers, investment firms, asset managers, insurance and mortgage brokers and consumer credit firms. The overall approach to the extension of the SM&CR and the implications for those firms that will be brought within scope, are discussed in more detail in Chapter 2.

1.12 The government has decided to introduce a statutory duty on senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility. This will apply across all authorised financial services firms. In the event of such misconduct, the senior managers can be guilty of misconduct if they failed to take such steps. The burden of proving this misconduct will fall on the regulators, as with other regulatory enforcement actions. This statutory duty of responsibility will supersede the ‘reverse burden of proof’ in the existing SM&CR proposals for the banking sector. These changes (and other mainly technical changes to the SM&CR) are discussed in Chapter 3.

1.13 The expected timetable for implementation is discussed in Chapter 4.

Extension of the Senior Managers and Certification Regime

2

2.1 Extending the Senior Managers and Certification Regime (SM&CR) will create a fairer, more consistent and rigorous regime for all authorised financial services firms. This chapter sets out the main features of the regime, and how it will be extended beyond the banking sector.

Application of the SM&CR to banks and key features of the regime

2.2 The SM&CR will introduce a new regulatory framework for individual accountability to replace the Approved Persons Regime (APR) for banking sector firms from March 2016.¹ The new framework will have essentially three components:

- Senior Managers Regime (SMR)
- Certification Regime
- Rules of Conduct.

2.3 The **Senior Managers Regime** will directly replace the APR in its application to persons performing the senior roles in a firm. These roles (known as Senior Management Functions - SMFs) will have been specified in rules made by the PRA and FCA. Firms need to provide for individuals already approved to be 'grandfathered' into relevant roles in the new regime. Any firms planning a new senior manager appointment, or a material change in role for currently approved individuals, will need to prepare and submit an application to the regulators for approval.

2.4 The **Certification Regime** will apply to individuals who are not carrying out SMFs but whose roles have been deemed capable of causing significant harm to the firm or its customers by the regulators. The regime requires firms themselves to assess the fitness and propriety of persons performing other key roles, and to formally certify this at least annually. These roles ("significant harm functions") are also specified by the regulators in rules but the appointments are not subject to prior regulatory approval.

2.5 Under the SM&CR, the regulators will have the power to make **Rules of Conduct** which will apply to senior managers, certified persons and other employees. For senior managers (and other approved persons), these rules replace the statements of principle made under the APR.

2.6 The SM&CR therefore gives the regulators flexibility to ensure a more effective, better targeted regulation of individuals working in the banking sector. For the most senior persons working in firms there will still be prior regulatory approval of individual appointments through a robust assessment process. For less senior, but nonetheless important, positions firms will have to take responsibility for ensuring that the individual is 'fit and proper' on a regular basis, formally confirming this at least once a year. This improves upon the APR as the assessment is ongoing, as opposed to at a point in time under the current regime. The SM&CR will limit the number of individuals subject to prior regulatory approval to the top decision-makers in a firm

¹ In this context, "banking" means the activities of banks, building societies, credit unions (collectively known as "deposit takers") and certain investment firms that are regulated by the PRA for prudential purposes (as well as by the FCA for conduct of business purposes) (known as "PRA-regulated investment firms") and includes UK branches of corresponding foreign institutions.

while at the same time ensuring that the fitness and propriety of a far wider range of individuals is subject to a formal annual assessment by firms. Allowing Rules of Conduct to be applied to a much broader range of staff will also instil standards of good conduct across the financial services industry.

2.7 The PRA and FCA SM&CR rules were designed to apply proportionately to the different categories of banking sector firms. For instance, a number of requirements in the SMR were tailored to banks, building societies and credit unions with assets under £250 million proportionate to their size, complexity and corresponding potential impact on the regulators' respective statutory objectives. Likewise, the regulators developed customised rules for UK branches of foreign banks to reflect their powers and responsibilities as host state regulators of these entities.

Application of the regime beyond banking

2.8 The key features of the regime will be as applied to the banking sector. The principle of proportionality will be particularly important as the SM&CR is extended to the broader range of firms operating in the financial services industry. The regulators will ensure that the extended regime appropriately reflects the diverse business models operating in the UK market and is proportionate to the size and complexity of firms. Their proposals will be subject to consultation following the passage of the legislation necessary to implement the regime.

2.9 For firms other than insurers, the SM&CR will replace the APR. In the case of insurers, the Senior Insurance Managers Regime (SIMR) introduced by the PRA (and the changes to the APR applying to insurers made by the FCA) as part of the implementation of the EU Solvency II Directive, already incorporate some of the substantive ideas and principles underpinning the SM&CR. For example, the SIMR seeks to promote a clear allocation of individual responsibilities by prescribing a range of responsibilities which insurance firms must allocate among their approved persons and requires insurers to produce governance maps (equivalent to the responsibilities maps for banks in the SM&CR) to clarify their governance arrangements. The introduction of the SIMR will therefore pave the way for the application of the SM&CR to insurers.

2.10 The main effects for new firms being brought into the regime are expected to be:

- 1 A substantial reduction in the number of appointments that are subject to prior regulatory approval, although there may be some increase in costs per application, as firms prepare the documentation required by the new regime including 'statements of responsibility' and other required information.
- 2 Most current approved persons below senior management level are expected to become certified persons. Some roles in firms where prior regulatory approval is not currently required may also become certified person roles. There will be some costs for firms in complying with certification requirements but these are not expected to be large since firms will already have systems in place for monitoring and recording information about employees' performance and suitability to meet their own HR needs.
- 3 Firms may incur some additional costs from putting in place systems to ensure employees are notified about, and receive suitable training in, the Rules of Conduct that will apply to them.

2.11 The following table gives indicative figures for the number of firms and individuals currently within the APR, the SM&CR being implemented for banking, and estimates of the numbers that may be caught by the extended regime. These figures are a combination of actual figures, and where these do not exist, best estimates provided by the regulators.

Table 2.A: Numbers of firms and individuals subject to the APR and SM&CR

Type of firm	Firms	Approved persons	Senior managers (Estimate)	Certified persons (Estimate)
<i>Current scope of the SM&CR</i>				
Banks and PRA-regulated investment firms	340	35,000	3,100	32,000
Building societies	45	800	500	290
Credit unions	550	6,500	6,450	12
<i>Under the proposed extended SM&CR</i>				
Insurers	580	4,400	3,400	1,000
Investment firm ²	17,200	106,000	43,900	62,000
Consumer credit firms	42,000	50,000	45,000	3,000
<i>Source: FCA estimates</i>				

² Includes stockbrokers, securities and futures firms, asset managers, financial advisers etc i.e. traditional financial services firms regulated by the FCA before consumer credit regulation was transferred to the FCA on 1 April 2014.

Reforms to the Senior Managers and Certification Regime

3

Introducing a statutory duty of responsibility

3.1 The government has decided to introduce a statutory duty of responsibility to be applied consistently to all senior managers across the financial services industry. This supersedes the 'reverse burden of proof' which would have applied to banking sector firms when they become subject to the SM&CR in March 2016.

3.2 The same tough underlying obligation will remain on the individual to ensure that they take reasonable steps to prevent regulatory breaches in the areas of the firm for which they are responsible, but the burden will be on the regulators to prove that a senior manager has failed to do this.

3.3 Under the Approved Persons Regime (APR), the regulators may take enforcement action against an approved person if they have contravened the statements of principle that apply directly to them, or if the approved person is knowingly concerned in a breach of regulatory requirements by the firm. The version of the Senior Managers and Certification Regime (SM&CR) included in the Financial Services (Banking Reform) Act 2013 includes a third ground for the regulators to take enforcement action against senior managers in banks and other banking sector firms. There are two elements to this third ground and the regulators may only take enforcement action if both are met. The first element is that the firm has contravened regulatory requirements and that the breach occurred in the part of the business for which the senior manager is responsible. The second element (the 'reverse burden of proof') is that the senior manager is liable if he or she cannot show the regulator that he or she took the steps that it was reasonable for a person in that position to take to prevent the breach occurring or continuing, thus reversing the normal burden of proof. The government will amend the provisions so that the regulators will only be able to take action if they can show that the individual failed to take the steps that it is reasonable for a person in that position to take to prevent a regulatory breach from occurring.

3.4 The SM&CR is a robust regime providing the regulators with a bigger toolkit than the Approved Person Regime it replaces. In addition, the vast majority of the firms that will be brought into the extended SM&CR are much smaller than banks and have significantly less complex hierarchies. It would therefore be disproportionate to apply the reverse burden of proof to these firms. These arguments apply equally for smaller banking sector firms, including some building societies and all credit unions, which often rely on volunteers to perform senior management roles.

3.5 Extending the SM&CR with a duty of responsibility across the whole financial services industry will create a fairer, more consistent and rigorous regime for all financial services firms. As set out in Chapter 1, a consistent regime supports effective regulation of financial services groups and a level playing field, and removes opportunities for regulatory arbitrage.

3.6 The government will amend the Financial Services (Banking Reform) Act 2013 (Commencement No. 9) Order 2015 to ensure that the 'reverse burden of proof' does not come into effect when the SM&CR comes into operation for banking sector firms on 7 March 2016.

Application of Rules of Conduct to non-executive directors

3.7 The Bill also provides for the PRA and FCA to be able to make Rules of Conduct applying to non-executive directors (NEDs).

3.8 During the detailed implementation work on the SM&CR the regulators decided that it would only be appropriate for certain NEDs with specific responsibilities, such as chairmen and the chairs of key board committees, to be senior managers. This reflected a range of factors, including concern in industry about the proportionality of the regime for individuals holding non-executive roles.

3.9 As a result, however, the regulators will not have the ability to take enforcement action for misconduct against NEDs. This gap needs to be addressed as there are provisions in certain EU directives¹ that require Member States to be able to take action against members of an institution's management body (including NEDs). There may also be circumstances when it is appropriate to take enforcement action against NEDs, such as when a NED fails to act with honesty and integrity, and it is difficult to justify a position where enforcement action can be taken against relatively junior staff but not against board members.

3.10 Introducing the ability to make Rules of Conduct gives the regulators a greater range of options to ensure the right outcome for individuals carrying out these important roles in firms.

Removal of obligation to report breaches of rules of conduct to regulators

3.11 The Bill also removes an inflexible provision in FSMA which requires banking sector firms to report all known or suspected breaches of rules of conduct by any employees subject to those rules to the regulators. This is potentially a very costly obligation for firms, especially the larger firms which employ large numbers of staff, as they have to put in place detailed systems and controls to ensure compliance. Removing this obligation will result in a reduction in the cost to business of complying with the SM&CR. The regulators can ensure that they are notified of any information about employee misconduct in a more proportionate way in their rules.

3.12 The government will amend the Financial Services (Banking Reform) Act 2013 (Commencement No. 9) Order 2015 to ensure that this obligation does not come into force when the SM&CR comes into operation for banking sector firms on 7 March 2016.

Giving regulators greater powers to make transitional provision

3.13 The Bill corrects a technical defect in the APR/SM&CR provisions in FSMA as originally enacted. FSMA confers extensive rule-making powers on the regulators, including a general power to make transitional provision in connection with their other rule-making powers. However, these powers do not allow the regulators sufficient flexibility in making 'grandfathering' provisions or dealing with existing approvals when new controlled functions are introduced or existing functions changed. This means that the 'grandfathering' provisions may have to be included in transitional and savings provisions orders made by the Treasury under transitional powers, as happened during the implementation of the SM&CR for banking sector firms. Without such Treasury provisions, the ability of the regulators to change the SM&CR is

¹ For example the Capital Requirements Directive: 2013/36/EU.

restricted and firms may have to make fresh applications for approval of all the approved persons or senior managers concerned. This would either be very burdensome for the firms concerned or administratively cumbersome for government. The Bill therefore confers the necessary powers on the regulators which they can exercise when they make changes to the structure of senior management functions. It also reserves to the Treasury the power to make transitional provisions which it is more appropriate for the government to make - for example, provision altering the powers of either regulator.

Allowing variation of time limits on senior manager approvals

3.14 Senior manager approvals can be made subject to conditions or time limits. The conditions (but not the time limits) can subsequently be varied on application by the firm or on the regulator's own initiative. The Bill alters this by allowing time limits on senior manager approvals to be varied in the same way as conditions.

Allowing separate statements of responsibility to be sent to the PRA and FCA

3.15 The Bill also makes a technical change to the application process for senior managers. This clause enables both regulators to receive updates to statement of responsibilities for senior managers.

4 Timing and implementation

4.1 The SM&CR will come into operation for banks, building societies, credit unions and PRA-regulated investment firms on 7 March 2016 apart from, as discussed above, the presumption of responsibility and the requirement to notify breaches of rules of conduct. Banking sector firms have also been given until 7 March 2017 to complete the certification of existing staff.

4.2 Clearly implementation for about 60,000 firms in a wide range of sectors from “traditional” financial services (financial advisers, asset managers, stock brokers etc) and consumer credit firms will be very challenging.¹ That said, it will be important, in view of the improvements to conduct regulation that the SM&CR will deliver, to extend the regime to all authorised financial services firms as soon as practicable. The government and the financial services regulators are determined therefore to set a stretching but realistic plan for ensuring effective implementation.

4.3 The government therefore intends that implementation of the newly extended regime should come into operation during 2018. This will allow the regulators to engage effectively with all affected stakeholders and consider in detail important issues such as proportionality and the lessons learned through the implementation of the SM&CR for banking sector firms.

¹ The regulation of consumer credit firms was transferred from the Office of Fair Trading to the FCA on 1 April 2014. “Traditional” financial services simply means the firms other than insurers which the FCA regulated before that date.

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