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CLIENT ALERT

Near-Final Rules and Guidance for the Extension of the Senior Managers & Certification Regime

August 31, 2018

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In July 2018, the UK's Prudential Regulation Authority ("**PRA**") and Financial Conduct Authority ("**FCA**") published "near-final" rules[1] on extending the senior managers and certification regime ("**SMCR**") to insurers and all other firms offering financial services in the UK, including incoming branches of non-UK authorised financial services firms. The FCA also published a "Guide to the senior managers and certification regime for dual-regulated insurers"[2] which summarises its rules and provides guidance on the SMCR. The PRA published an updated version of its supervisory statement SS35/14 on "strengthening individual accountability in insurance"[3].

Background to the July Publications

The SMCR is an enhanced individual accountability framework which, since March 2016, has applied to directors and senior managers of banks, building societies, credit unions and dual-regulated investment firms. The SMCR will apply to insurers from 10 December 2018 and to all other UK-regulated firms from December 2019. The extent of the rules will depend on whether a firm is a "Core SMCR Firm", an "Enhanced SMCR Firm" or a "Limited Scope Firm".

The FCA has, through 2017 and early 2018, consulted on the extension of the SMCR to all solo-regulated firms and both the PRA and FCA have also, during this period, consulted on extending the regime to insurers, which are currently subject

1 PRA Policy Statement PS15/18. Available here; FCA Policy Statement PS18/15. Available here; FCA Policy Statement PS18/14. Available here.

2 The Senior Managers and Certification Regime: Guide for insurers. Available here.

3 Contained within Appendix 2 to PRA Policy Statement PS15/18.

to the Senior Insurance Managers Regime. While the latest regulatory publications do not represent significant departures from the earlier proposals, the regulators have clarified a number of outstanding issues which were raised by industry participants during the consultation processes. Please see our previous client briefings: Extension of the Senior Managers and Certification Regime by the UK's FCA and Extension of the Senior Managers and Certification Regime by the UK's FCA to Insurers.

Summary of Key Points Applicable to All Firms Following the Consultation

- The FCA has removed the proposed Prescribed Responsibility for Core SMCR Firms to inform a firm's governing body of their legal and regulatory obligations. The FCA reasons that Senior Managers are already obliged to ensure that the business area for which they are responsible complies with relevant legal and regulatory requirements and is controlled effectively in line with the FCA's Senior Manager Conduct Rules.

- The FCA has retained the full list of "Senior Management Functions" (for high-level senior management) and "Certification Functions" that are subject to the certification regime (for people who are not senior managers, but who are involved in aspects of the firm's affairs that might involve a risk of significant harm to the firm or any of its customers) for solo-regulated firms. It has provided further guidance on how these functions should be applied.

- The FCA has noted that firms should apply the certification requirements proportionately to different functions. As such, different criteria for fitness and propriety can be applied depending on a person's seniority or role.

- The FCA has confirmed that a Senior Manager who performs a Certification Function in addition to, and different from, his or her Senior Management Function will need to be certified in respect of that function in addition to, and separate from, receiving regulatory approval in relation to the Senior Management Function he or she performs.

- The Client Dealing Certification Function is broader than the current CF30 role under the Approved Persons Regime and covers any individuals advising or dealing for clients, including retail and professional clients. It does not include the ability to advise on or arrange non-investment insurance products.

- The FCA has noted that Brexit may necessitate amendments to the SMCR rules, but as the SMCR reflects UK, rather than EU, regulatory policymaking these are unlikely to be extensive and would only affect EEA firms and branches.

Summary of Key Points Applicable to Insurers Only

- The FCA is continuing with its proposal to create a specific Conduct Risk Oversight Officer Senior Management Function for Lloyd's and has provided more clarity over the scope and responsibility associated with the role. The FCA has said that its aim "is that there is a Senior Manager in Lloyd's who is clearly accountable for monitoring and overseeing Managing Agents' compliance with Lloyd's conduct of business standards". The FCA does not consider this accountability to overlap with the roles of other managers carrying out Senior Management Functions within Lloyd's Managing Agents.

- The list of Prescribed Responsibilities applicable to insurers differs from the list for FCA solo regulated firms. In spite of consultation feedback, the regulators are of the view that insurers face different risks and this justifies the need to set different Prescribed Responsibilities.

- Although additional guidance beyond what is already set out in the FCA's Handbook will not be provided on Statements of Responsibilities, in order to help firms meet the new requirements the FCA is developing best practice examples of how firms can prepare their Statements of Responsibilities.

- There are no changes to the proposals regarding Responsibilities Maps but clarification has been provided as to their contents and preparation. The PRA has set out further detail as to its expectations on Statements of Responsibilities and Management Responsibilities Maps in the updated supervisory statement SS35/14 on "strengthening individual accountability in insurance".

- In relation to small non-directive firms, such as insurance intermediaries, the PRA has reduced the certification requirements in that only members of such a firm's governing body will be included within the Certification Regime.

A New Financial Services "Directory"

Following the extension of the SMCR, it will only be individuals carrying out Senior Management Functions who will be required to be approved by the regulators and whose names will appear on the Financial Services Register. This will substantially reduce the overall number of individuals included on the Financial Services Register.

In response to concerns raised by firms during the FCA's consultation, the FCA is proposing to introduce a new publically-accessible directory of individuals at firms (including banks). This will allow consumers and other interested parties to access information about individuals performing most front/middle/back office functions at firms. The directory is proposed to include information on relevant individuals, including their workplace location, qualifications and any prior regulatory sanctions and prohibitions.

The FCA has issued a consultation[4] on this proposal and is accepting responses to the consultation until 5 October 2018.

[4] FCA Consultation Paper CP 18/19. Available here.

Comments on the Duty of Responsibility

Since the introduction of the SMCR, Senior Managers of banks have been subject to a statutory Duty of Responsibility requiring them to take reasonable steps to prevent regulatory breaches in contexts for which they are responsible. The FCA has confirmed that the statutory duty will be the same for all firms within the scope of the SMCR and no changes to the FCA's rules, aside from definitional amendments, were required.

As a reminder, the Duty of Responsibility specifies that the FCA can take action against a Senior Manager where it can show that:

- there was misconduct by the Senior Manager's firm;
- at the time of the misconduct or during any part of it, the Senior Manager was responsible for the management of any of the firm's activities in relation to which the misconduct occurred; and
- the Senior Manager did not take such steps as a person in their position could reasonably have been expected to take to avoid the misconduct occurring or continuing.

The burden of proof for all these elements lies with the FCA. The Senior Manager does not need to show that he or she took reasonable steps; rather it is for the FCA to prove that he or she did not.

The Duty of Responsibility merely requires that Senior Managers take reasonable steps. Even if they do not, no liability arises under the Duty without associated firm misconduct. Further, the burden is on the FCA to prove both the absence of those steps and the firm's misconduct.

The FCA's guidance already states that it will take account of all the circumstances in determining what steps the FCA considers a person in the relevant Senior Manager's position could reasonably have taken. These include the Senior Manager's particular role and responsibilities and the scale and complexity of the relevant firm's business.

The guidance also already states that in establishing what those responsibilities were, the FCA will take into account, beyond statements of responsibility and organisational charges, how the relevant firm operated and how responsibilities were allocated in practice.

The FCA will need to show that the relevant Senior Manager did not take the steps a person in his or her position could reasonably have been expected to take to avoid his or her firm's relevant misconduct occurring or continuing.

It is recommended that firms keep records of relevant steps they take, in case questions are raised, whether by their firm, its lawyers, auditors, insurers or customers, or the FCA or another regulator. The FCA makes the point in its guidance that such records might be relevant not only to compliance with the Duty of Responsibility but also general FCA rules requiring firms to act with due skill, care and diligence.

Timing and Preparation

The regulators have confirmed that the SMCR will be extended to solo-regulated firms with effect from 9 December 2019 and to insurers from 10 December 2018. All firms will have a 12 month "grace period" within which to complete their first round of annual assessments of the fitness and propriety of employees carrying out Certification Functions. The FCA adopted the same transition period approach when the SMCR was introduced for banks and building societies in 2016. Firms will need to submit a "Form K" (including Statements of Responsibilities) for converting approved persons to Senior Management Functions by no later than one week before the relevant December 2019 implementation date.

Practical Steps for Implementation

Firms should start preparation for implementation by taking the following steps:

- assess whether they are a "Limited Scope Firm", a "Core SMCR Firm" or an "Enhanced SMCR Firm" as the detail of the applicable rules follow from this;
- identify those individuals who will be Senior Managers, and which prescribed responsibilities will apply to them;
- agree and map Statements of Responsibilities with relevant Senior Managers; this may have implications for their employment contracts;
- establish processes around the provision of regulatory references and annual certification of staff;
- establish processes for interacting with and updating the proposed new Financial Services Directory;
- in connection with the Duty of Responsibility, consider what are "reasonable steps" and how these will be evidenced and recorded;
- implement a new training program for all staff covered by the conduct rules; and
- Enhanced Firms will need to implement a handover procedure and policy to be used when there is a change in a Senior Manager.

Territorial Scope and Brexit

The SMCR applies to any individual performing a relevant role whether they are based in the UK or overseas. If therefore a firm is part of an overseas group, and an individual is responsible for implementing strategy in the UK, and has not delegated that responsibility to a Senior Manager in the UK, that individual is likely to be performing a Senior Management Function. If an Overseas Manager's responsibilities are strategic only, i.e., without an implementation role, he or she is unlikely to be a Senior Manager. For firms with a UK branch, the rules currently distinguish between branches of EEA firms and those of third-countries. Branches of third country firms have eight prescribed responsibilities to be allocated to Senior Managers, whereas branches of EEA firms have none.

Our experience working with UK-regulated clients suggests that firms will need to ensure they undertake a significant amount of preparation and forward planning to be ready for the transition from the existing Approved Persons Regime and Senior Insurance Managers Regime to the SMCR.

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