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The U.K. Senior Managers Regime: Certification Regime and Conduct Rules (Part Two of Two)

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A recent ACA Compliance Group (ACA) webinar provided a roadmap for fund managers to navigate the transition to the U.K. Senior Managers and Certification Regime (SMCR), which will apply to the financial services industry in its entirety on December 9, 2019, and introduces, among other things, heightened levels of personal responsibility and accountability. The program, entitled "Senior Managers & Certification Regime: What You Need to Know," featured Martin Lovick, ACA senior principal consultant; Josie Cooper, ACA consultant; and Dimitrios Sachinidis, ACA senior compliance analyst.

This article, the second in a two-part series, summarizes the panelists' insights on the firm-based certification of certain other personnel (Certification Regime), the imposition of rules of conduct on virtually all firm employees (Conduct Rules) and steps fund managers can take toward compliance. The first article covered the genesis and extension of the SMCR, as well as the responsibilities of senior managers.

For additional commentary from ACA, see "Developing a 2018 Compliance Budget: How Investment Advisers Can Make the Most of Limited Resources" (Dec. 21, 2017); and "Challenges and Solutions in Managing Global Compliance Programs" (Oct. 5, 2017).

Certification Regime

Unlike the SMCR, which bears similarities to the Approved Persons Regime (APR), the Certification Regime is entirely new, Lovick noted. It applies to firm personnel who are not senior managers but who are in position to cause harm to the firm, its customers or market integrity, Sachinidis explained. As under the APR, these people must still be "fit and proper," but the duty to determine whether they are will shift from the U.K. Financial Conduct Authority (FCA) to firms. Firms must identify all persons subject to the Certification Regime by December 9, 2019, and must issue certificates to those persons by December 9, 2020.

Those certificates must "set out the concerned individual's fitness and propriety through the prism of the firm's business in which the individual is involved," Sachinidis clarified. A certificate, which must be tailored to the individual, must be issued when a person joins a firm and then annually thereafter. The annual fit and proper assessment may coincide with the annual appraisal process.

Certification functions include a client dealing function that is virtually identical to the current CF30 customer function under the APR, but they capture a broader range of people, Lovick said. Individuals involved in trading, material risk taking, supervision of certified functions, client dealing and significant management functions all have to be certified, Sachinidis said. Many of those individuals are probably already approved persons under the APR, but there is no automatic transition to the Certification Regime, he cautioned. Therefore, firms must identify and certify all individuals performing certification functions. Some firms, especially small ones, may not have any certification functions. Those that do must determine what senior manager will have oversight of certified individuals.

If a person holds both a SMF and a certification function, the FCA will assess the person as a senior manager, and the firm will have to certify the person for the relevant certification function, Cooper added.

Key Steps for Certification

Assessment of whether a person is fit and proper under the Certification Regime is similar to the assessment under the APR, Sachinidis continued. There are three fundamental criteria:

1. *Honesty, Integrity and Reputation*: A firm must conduct background checks, request references from previous employers and use other checking tools to assess new hires. Personal reference requests are usually made to the relevant professional body. Annually, the assessor must express a view on the employee's honesty, integrity and reputation based on the use of those checking tools.
2. *Competence and Capability*: Firms should consider a candidate's resume, professional qualifications, interview performance and scores on any internal exams. Firms must periodically evaluate the employee's compliance with professional qualification requirements and efficiency in carrying out her duties.
3. *Financial Soundness*: This is assessed both initially and periodically, primarily through credit checks and, secondarily, through reference checks to individuals in a position to vouch for the person's financial soundness.

Firms should develop plans for dealing with persons who are not fit and proper, Sachinidis added. They should focus on the areas that caused an individual to fall short. Remedies may include additional training or demanding a professional qualification, if one was not previously required.

Financial Services Register and Directory

The FCA's Financial Services Register is a public database of individuals and firms that are regulated by the FCA or the U.K. Prudential Regulation Authority (PRA). The register will only include approved senior managers, Sachinidis observed. Therefore, some individuals will be removed from the register because they will no longer be approved persons, including those presently holding CF2, CF28, CF29 and CF30 approvals.

The FCA is consulting on a new directory intended to include all firm-certified individuals, non-executive directors, sole traders and appointed representatives, Sachinidis added. Firms will be responsible for keeping the new directories up to date. All firms regulated solely by the FCA (solo-regulated firms) must submit all relevant data by December 9, 2020. Firms that do not file updated data in a 12-month period will be asked to confirm that there have been no changes, he added.

Conduct Rules

The Conduct Rules under the SMCR are similar to the current FCA Statements of Principle for approved persons, Lovick noted. They take effect from December 9, 2019, Sachinidis explained. The rules apply to virtually all staff. They are the "key element of SMCR that seeks to encourage a culture whereby staff at all levels take personal responsibility for their actions," he said. The Conduct Rules may capture employees who are not presently covered, such as analysts who do not have decision-making responsibility for investment management. The only individuals excluded from the rules are "ancillary" staff whose roles are not specific to financial services. Firms should be prepared for employee questions about the relevance of the Conduct Rules to their specific roles.

There are two tiers of Conduct Rules, which are set out in the FCA handbook and guide for solo-regulated firms (Guide). The first tier includes the following five rules, which apply to all individuals other than ancillary staff:

1. Act with integrity.
2. Act with due care, skill and diligence.
3. Be open and cooperative with the FCA, the PRA and other regulators.
4. Pay due regard to the interests of customers and treat them fairly.
5. Observe proper standards of market conduct.

The following four additional Conduct Rules apply exclusively to senior managers:

- SC1: Take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
- SC2: Take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.
- SC3: 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.
- SC4: Appropriately disclose any information of which the FCA or PRA would reasonably expect notice.

The Guide includes the following list of what the FCA considers "ancillary" staff positions:

- receptionists;

- switchboard operators;
- mailroom staff;
- reprographics/print room staff;
- property/facilities management;
- events management;
- security guards;
- invoice processing;
- audio-visual technicians;
- vending machine staff;
- medical staff;
- archive records management;
- drivers;
- corporate social responsibility staff;
- data controllers and processors under the data protection act;
- cleaners;
- catering staff;
- personal assistants and secretaries;
- information technology support (*i.e.*, helpdesk); and
- human resources administrators/processors.

The Conduct Rules empower the FCA to take enforcement action to address both financial and non-financial misconduct, Sachinidis cautioned. The FCA is putting non-financial misconduct, such as sexual misconduct, on the same footing as financial misconduct.

See "FCA Executive Director Emphasizes Need for Fund Managers to Promote Diversity" (Jan. 24, 2019).

Compliance Training

SMCR training should be conducted annually, both by category and by topic, Sachinidis said. For example, senior managers should be trained on the duty of responsibility and "reasonable steps," while traders will have to understand Conduct Rule 5. Training should include "specific examples of good and bad behavior," he added.

Firms have a duty to ensure that employees understand the rules, the consequences of a breach and the possibility of enforcement action. Senior managers and certified staff must be trained by December 9, 2019. All other staff subject to the Conduct Rules must be trained by December 9, 2020.

See "How to Avoid Five Common Duty to Supervise Traps: Respond to Red Flags; Implement Reasonable Policies and Procedures; and Conduct Adequate Training (Part Three of Three)" (Sep. 20, 2018); "High- and Low-Tech Innovations for Fund Managers to Overcome Compliance Training's Drawbacks" (Feb. 1, 2018); and "Early and Often: Compliance Training Pays Big Dividends for Private Fund Advisers" (Jul. 8, 2009).

Breach Reporting

The FCA has brought several successful high-profile enforcement actions against senior individuals who were banned for conduct deemed not fit and proper, Sachinidis noted. The FCA seeks to deter even minor misconduct. Under the SMCR, in addition to reporting breaches to the FCA, a firm must also include details of breaches in regulatory references. Different people may reach different conclusions as to whether a breach occurred. Therefore, legal and human resources personnel must cooperate with compliance in addressing conduct issues. Firms should continue to report breaches by senior managers on Form D. There is a new Form REP008 for reporting breaches by staff subject to the rules.

Five Key Steps Toward Compliance

Firms should treat the SMCR as a significant regulatory implementation project in its own right, Lovick advised. Many firms have indicated that they will begin implementation in the first half of this year. There are five key steps to facilitate compliance with the regime. With a little more than seven months to go until the SMCR takes effect, a firm may wish to devote about six weeks to each of the following steps, he said:

1. Put together a project team with appropriate time, authority and resources. The team should understand the relevant requirements and conduct a gap analysis. Compliance will probably play a leading role on the team, which should also

include operations, human resources and legal personnel.

2. Engage with the senior management team on the requisite changes. The SMCR may "ruffle some feathers," Lovick said, adding, "Most of us like being in a position of power and authority, but we are probably less keen on the idea of being held accountable."
3. Implement processes for fit and proper assessments, certifications and breach investigations.
4. Update policies, procedures and compliance manuals, and create statements of responsibility and other requisite documentation.
5. Train senior managers and all other staff. Two separate training sessions would probably make sense.

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