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# SMCR Themes, trends and challenges

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# Ten years on from the Parliamentary Commission on Banking Standards and its instruction to regulators to tackle the “accountability firewall”

In 2013, the Parliamentary Commission on Banking Standards condemned the Approved Persons Regime as a “complex and confused mess” which “fails to perform any of its varied roles to the necessary standard... its coverage is woefully narrow and it does not ensure that individual responsibilities are adequately defined, restricting regulators’ ability to take enforcement action”. Fast-forward ten years – in 2023:



Source: The Parliamentary Commission on Banking Standards: “Changing banking for good” (June 2013).





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01 Navigating the regulatory gateway

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02 Enforcement appetite under the SMCR

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03 Senior Managers and “reasonable steps”

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04 Handling employee misconduct

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# Navigating the regulatory gateway



# The FCA as a more “assertive” regulator: Putting this approach into practice

There has been a noticeable shift in the FCA’s tone when it talks about its approach to the gateway, both in relation to firms and individuals, prompted by the FCA’s commitment to becoming a more “assertive” regulator in July 2021.

“As we transform into a more assertive regulator, we have strengthened our assessment at the Gateway. As part of this we review firms’ business plans, risks, budgets, resources, systems, controls and whether key staff have the necessary qualifications and experience to carry out their roles effectively.”

*FCA Annual Report 2021/22*

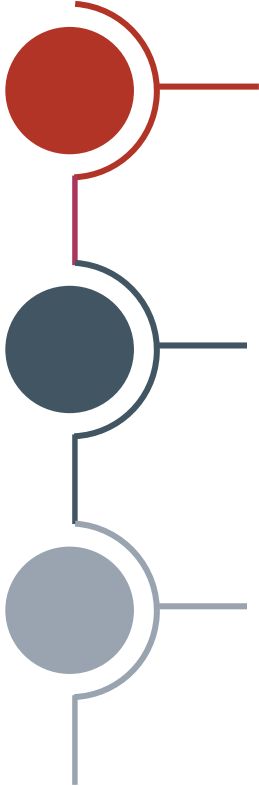
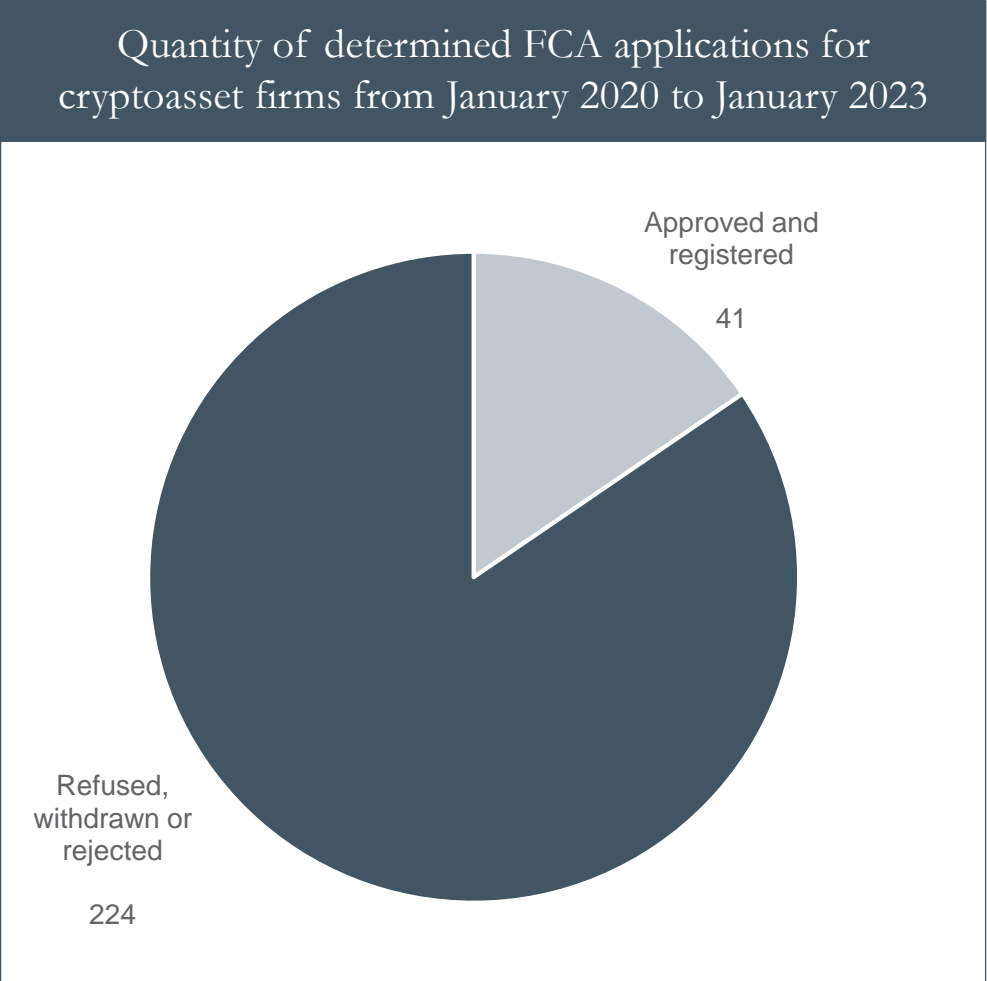
“We set the bar high for new entrants to ensure that firms and individuals are able to meet our standards and rules at this gateway, and continue to do so, to achieve good outcomes for consumers and markets”.

*FCA Annual Report 2021/22*

“The FCA today makes a commitment to be a more, innovative, adaptive and assertive regulator... The FCA must continue to become a forward-looking, proactive regulator. One that is tough, assertive, confident, decisive, agile”.

Nikhil Rathi, FCA Chief Executive  
(July 2021)

# The tougher regulatory gateway in action: MLRs applications for cryptoasset firm registrations



The FCA has been the AML/ CFT supervisor of UK cryptoasset businesses since 10 January 2020. Since then, it has received over 300 applications for registration under the MLRs and determined over 260 as of January 2023

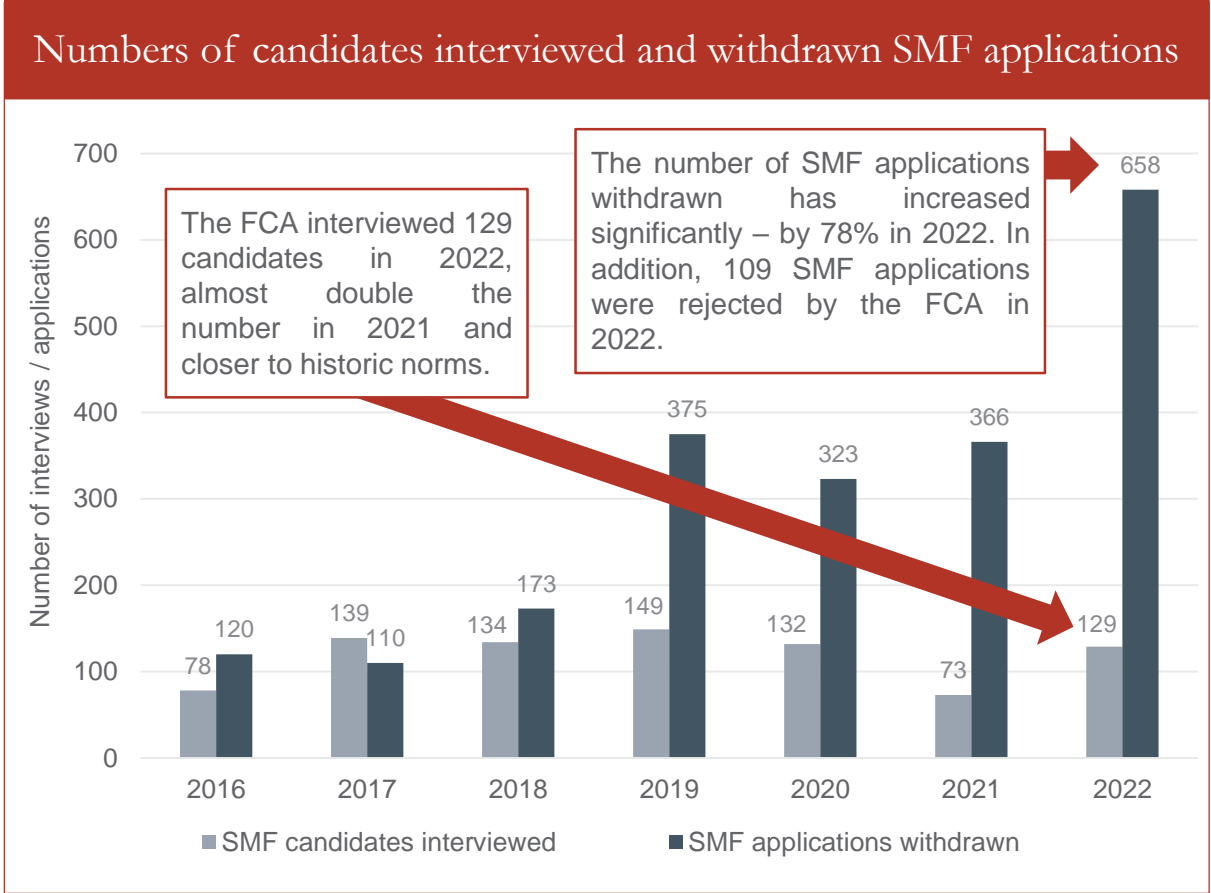
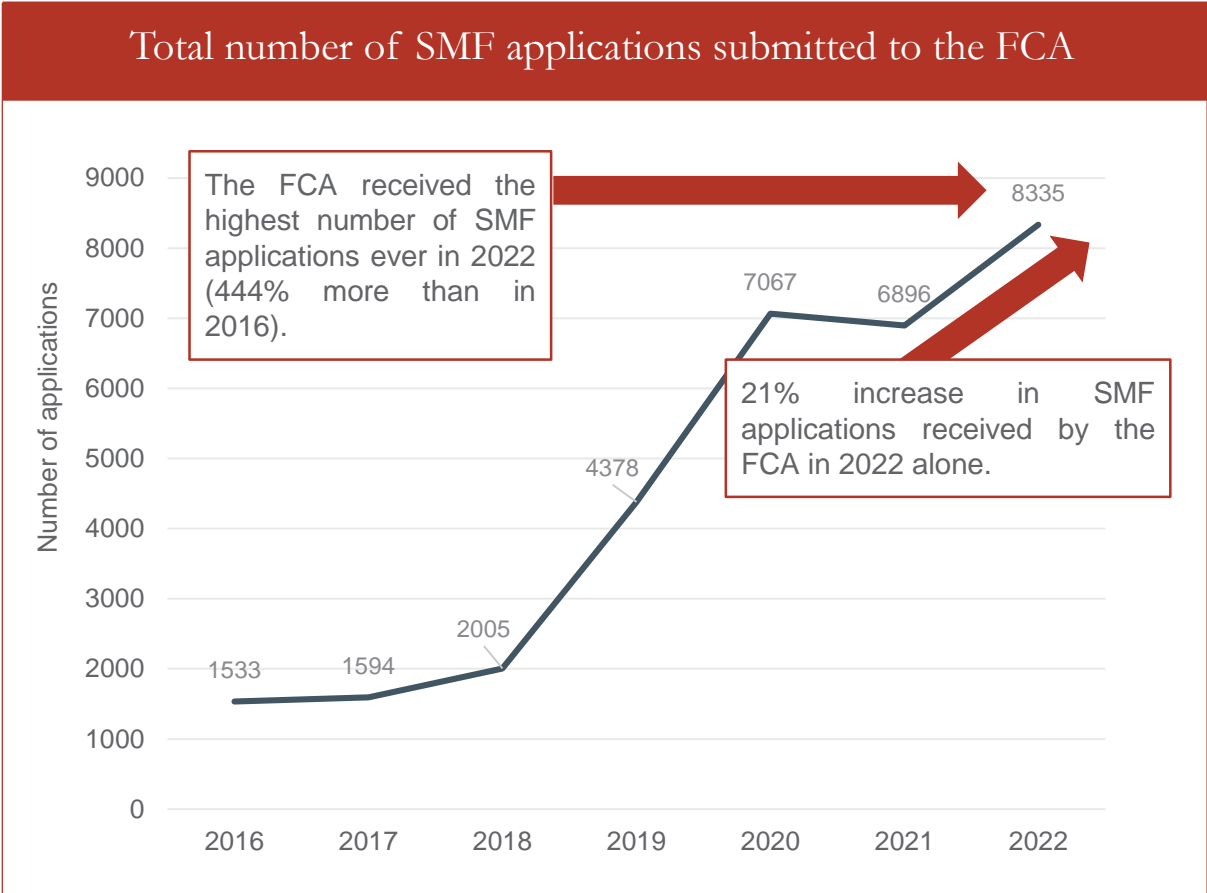
The FCA published extensive guidelines for submitting an application, providing guidance in areas such as business plans, risk assessment, MLRO nominations and blockchain compliance.

Since then, the vast majority (85%) of these applications have been refused, withdrawn or rejected.

Source: Cryptoasset AML/CTF regime: feedback on good and poor quality application, January 2023

# What the more stringent regulatory gateway looks like for Senior Manager candidates

Senior Manager candidates are feeling the effects of the FCA’s more stringent gateway, with more candidates for SMF roles being interviewed and a record number of SMF applications being withdrawn. All this points towards the FCA scrutinising SMF applications in a lot more detail.




Sources: Freedom of Information Act requests | Allen & Overy research.




# Senior Manager interviews: Key topics to expect


The number of Senior Manager applicants required to attend FCA interviews in 2022 increased significantly from the previous year, reflecting the increasing focus of the FCA at the gateway. Those who are required to attend interviews need to ensure that they are thoroughly prepared for them and are ready to discuss the following topics as they relate to their role and business.


 **Understanding of the role** applied for, its key responsibilities, and what it means to be a **Senior Manager**


 **Knowledge, skills and experience** which make the candidate suitable for the role, including any **development points**

 Reporting lines, escalation routes, and **potential for conflicts**


 **Key relationships** and how the Senior Manager will manage these, especially within large, complex organisations


 The candidate's approach to **Leadership**, and the leadership challenges the role presents


 The candidate's view of how the **relationship with the regulator** should be approached.

 **Market knowledge**, including the business, economic and market environment in which the firm operates.

 **Business model and strategy**, and the key risks that flow from these.

 **Regulatory priorities for the firm and the sector**, including the Senior Manager's honest assessment of existing gaps, and how these should be closed

 **Governance, oversight and risk management** at the firm, including areas in need of improvement.

 **Consumer Duty**, including its application to the firm, progress to date, and further effort needed.

 **Culture and D&I**, including Senior Manager understanding of the importance of culture and commitment to D&I



# Key “do’s” and “don’ts” for Senior Manager interviews

Senior Manager interviews should be professional and non-confrontational interactions, with the candidate offering to expand on points made, and co-operating with the regulators in providing honest and fulsome information.

## “Do’s”

- 01 Use a professional and respectful tone, seek to build rapport with the interview panel, and “read the room”.
- 02 Sell yourself – use examples to illustrate key strengths and experience, and to evidence relevant capabilities
- 03 Be honest about personal development needs, and the areas where the firm is still developing maturity or needs further work
- 04 Aim to demonstrate an awareness that the regulator’s agenda is “shared”, and that a Senior Manager’s and regulator’s interests will typically align.
- 05 Seek to paint a picture of strong leader and risk manager who will be effective in “owning” their role.

## “Don’ts”

- 01 Seek to filibuster or run down the clock with long answers – you have to pass the interview, not simply avoid failing it!
- 02 Be overly optimistic or unrealistic, or present a “nothing to see here” attitude.
- 03 Exaggerate, tell half-truths, or make up answers. All responses must be entirely honest and accurate.
- 04 Ask questions that seek to draw out the regulator’s view of the firm – stick to process questions.

# Enforcement appetite under the SMCR



# Enforcement appetite under the SMCR: The current landscape

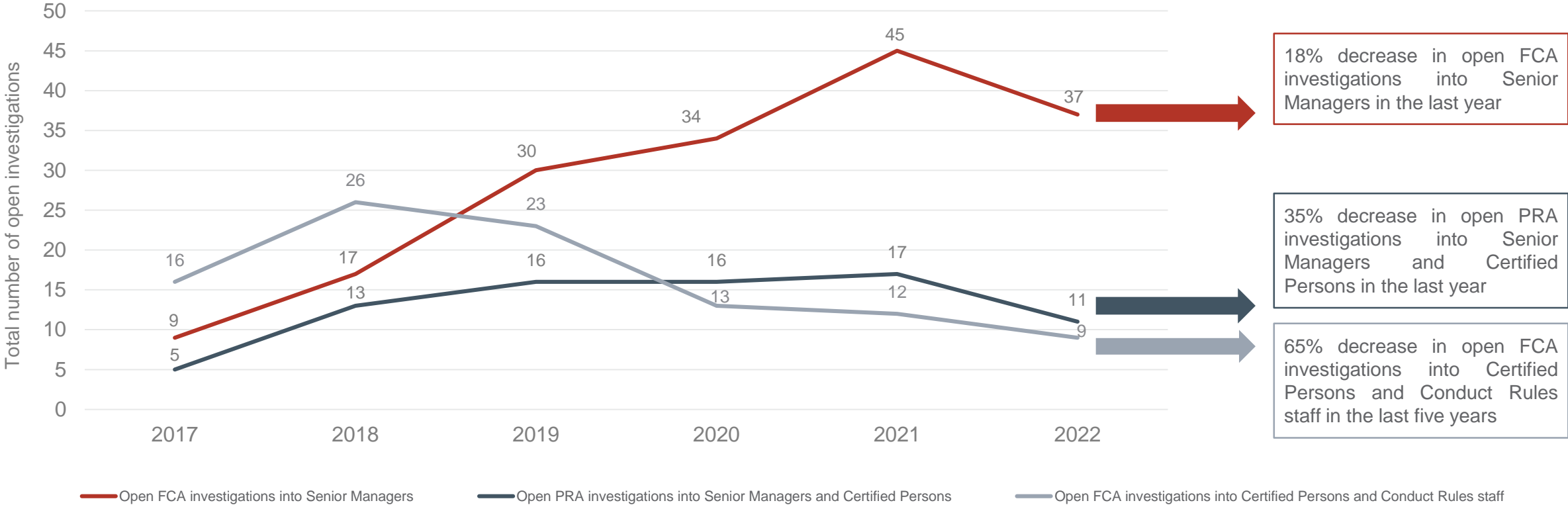
The latest figures from the FCA and the PRA show a continued modest appetite to opening enforcement investigations into individuals who are subject to the SMCR.



Sources: Freedom of Information Act requests (as at 31 December 2022); FCA and PRA Annual Reports; FCA and PRA Final Notices | \* The Senior Manager had enforcement action taken against them by the FCA and the PRA in relation to the same underlying facts. Excludes enforcement action taken solely to impose a prohibition order due to a lack of fitness and propriety.

# Surprisingly, the number of open enforcement investigations into Senior Managers, Certified Persons and Conduct Rules Staff has dropped quite significantly over the last few years

As the number of firms and individuals subject to the SMCR increased (as did the length of time the SMCR had been in force), we expected the number of FCA and PRA enforcement investigations to increase. Although this showed signs of being an accurate prediction, the latest numbers from the FCA and the PRA tell a somewhat different story.



Sources: Freedom of Information Act requests (as at 31 December 2022) | Allen & Overy research.



# Key senior management issues and criticisms highlighted in enforcement action taken against firms by the FCA and the PRA

Even though there has been a lack of enforcement action against Senior Managers, the FCA and PRA have not shied away from making criticisms about senior management more generally in enforcement action taken against firms.



Lack of clarity about or failure to obtain necessary senior management approvals.



Lack of escalation of issues and information to (and also between) senior management.



Senior committees not working effectively to help senior management discharge their obligations.



Lack of meaningful senior management engagement in key issues or decisions.



Failure to clearly assign roles, responsibilities and reporting lines among key employees.



Senior management reliance on inadequately resourced or experienced teams.



Inadequate senior management review and use of management information.



Senior management reliance on poor quality / inaccurate management information.



Lack of documentation to show that senior management arrangements are working effectively.



Failure to adequately oversee, demonstrate sufficient influence over or drive forward remediation projects.

# Enforcement action and the SMCR – what to expect next

The FCA will shortly have a new Director of Enforcement and Oversight, who will no doubt want to stamp their own mark on the direction of the FCA’s enforcement agenda – including when it comes to enforcement action against individuals under the SMCR. But there are plenty of legacy cases still ongoing that provide an indication of what we can expect over the coming months.



**The Upper Tribunal:** A number of important Upper Tribunal cases are due to be heard this year, which will involve findings relevant to the SMCR.



**“Knowingly concerned”:** Following a Court of Appeal judgment last year, the Upper Tribunal will consider this test.



**Outstanding warning notice statement:** Issued in October 2021 (for alleged breaches of Individual Conduct Rule 1 (integrity)). Outcome still pending.



**Contentious SMF applications:** Higher numbers of refusals and invitations to withdraw applications means that the process is getting more contentious.

## SMF approvals: A second bite at the (enforcement) cherry?

- In November 2022, the FCA published a decision notice to a firm, refusing its application for an individual to perform the SMF1 (Chief Executive) and SMF3 (Executive Director) roles.
- The FCA stated that it was not satisfied that the individual is fit and proper to perform those SMFs as “there are reasonable grounds for considering that in interviews with the [FCA] in relation to two different investigations” that the individual “failed to be open and cooperative and gave untrue and misleading evidence”.
- The FCA is not satisfied as to the individual’s honesty and integrity.
- These investigations concern events that happened and evidence provided to the FCA over 10-15 years ago.
- The FCA’s decision has been referred to the Upper Tribunal.



Senior Managers and  
“reasonable steps”

# “Reasonable steps”: Why do they matter for Senior Managers?

The concept of “reasonable steps” underpins three of the four FCA / PRA Senior Manager Conduct Rules, as well as the Duty of Responsibility. It has been tested on multiple occasions under the Approved Persons Regime, but not yet under the Senior Managers Regime.

## The underlying obligations for “reasonable steps”



**SM Rule 1:** You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.



**SM Rule 2:** You must 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.



**SM Rule 3:** You must 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.



**Duty of Responsibility:** The Senior Manager did not take such steps as a person in the Senior Manager’s position could reasonably be expected to take to avoid a breach of regulatory requirements from occurring or continuing.

## How “reasonable steps” are tested in practice

### Circumstances

What has happened and why?



### Responsibilities

What was the Senior Manager responsible for?



### Reasonableness

What were the “reasonable steps” that the Senior Manager should have taken at the time, taking into account their position, role and responsibilities and the circumstances that they faced at the relevant time?



# But what constitutes “reasonable steps” in practice?

## The million dollar question

The FCA and the PRA have published some limited and non-exhaustive guidance on “reasonable steps”, but further official guidance on this topic is unlikely.



Role, responsibilities and tenure.



Consideration of available information.



Nature, scale and complexity of the business.



Knowledge that a SMF had (or should have had).



Dealing with issues in a timely way.



Effective delegation to others.



Clear and effective reporting lines.



Appropriate policies, systems and controls.



Governance and risk management arrangements.



Handovers and transitions between SMFs.



Understanding of the business and its risks.



Oversight of “star” performers and results.

“Many senior managers expressed concern around understanding the meaning of ‘reasonable steps’... often seeing the answer as being further guidance from the FCA....

However, it is not possible to provide an exhaustive list that would cover every situation.

Neither would it be helpful; our expectation of senior managers is that they should be doing what they reasonably can to prevent misconduct. Appropriate controls and processes are an important part of this but we also look to senior managers to think more broadly and to create an environment where the risk of misconduct is minimised, for example through nurturing healthy cultures”.

The FCA: Senior Managers and Certification Regime Banking Stocktake Report (August 2019)

# Key areas of current regulatory focus when it comes to Senior Managers’ “reasonable steps”

The concept of “reasonable steps” never stands still. What will constitute “reasonable steps” depends on specific circumstances, as well as changes in regulatory expectations and requirements. For example, the new Consumer Duty will bring with it significant changes to what is expected of Senior Managers and their “reasonable steps”, even though the wording of the legal requirements that apply to Senior Managers will not change.



# Senior Managers and “reasonable steps frameworks”

Many firms have chosen to memorialise their Senior Managers’ reasonable steps in formal framework documents. These documents come in many different shapes and sizes.



Not an “A to Z” of reasonable steps.



Cannot legislate for every situation.



Utilise existing frameworks / materials.



Keep the level of detail proportionate.



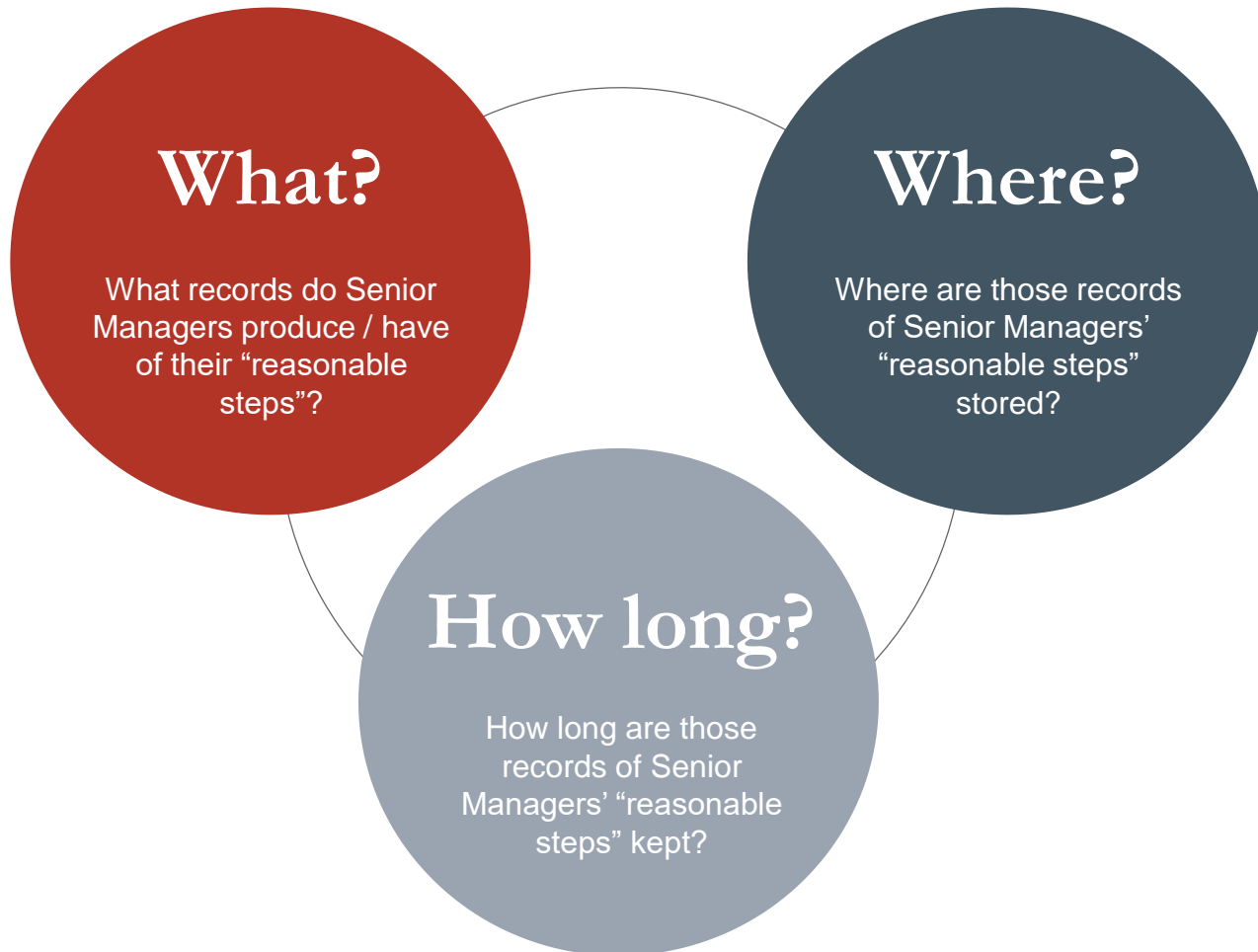
Consider how a document will be used.



Don’t forget about maintenance / updates.

# Recording “reasonable steps” taken by Senior Managers: Proportionality is key

Although Senior Managers rightly focus on what “reasonable steps” look like in practice, it is also essential to ensure that adequate (but proportionate) records of those reasonable steps are maintained.



## Key pointers about record keeping

- There is no ‘one size fits all’ approach.
- Some situations will require bespoke approaches (e.g. making a note of ad hoc escalations) but others may be standardised (e.g. regular 1:1s).
- Senior Managers can ask for support.
- Don’t always rely on email inboxes – although most firms keep emails for at least a few years, Senior Managers need to consider how they can access their records in the future.
- Consider arrangements for electronic documents and hard copy materials (if applicable).
- Think ahead. What will happen to a Senior Manager’s records when they leave, or move roles?



# Handling employee misconduct



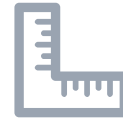
# Breaches of the FCA and PRA Code of Conduct: Are they getting any easier as time goes on?

On the whole, no. Some firms are building up valuable precedent banks of cases where they have had to assess whether there has been a breach of the Code of Conduct. However, plenty of grey areas remain and more difficult decisions lie ahead.



## Link to disciplinary action

Taking disciplinary action does not automatically mean that you must find that there has been a breach of the Code of Conduct in relation to the same underlying conduct.



## Proportionality

Different findings and sanctions must be in step with each other, e.g. disciplinary action and sanction, remuneration adjustments and assessment of Code of Conduct breaches.



## Integrity: More than just dishonesty

Integrity extends beyond dishonesty: it includes recklessness and conduct that falls below the standards of ethical conduct expected of a person of the same experience and seniority.

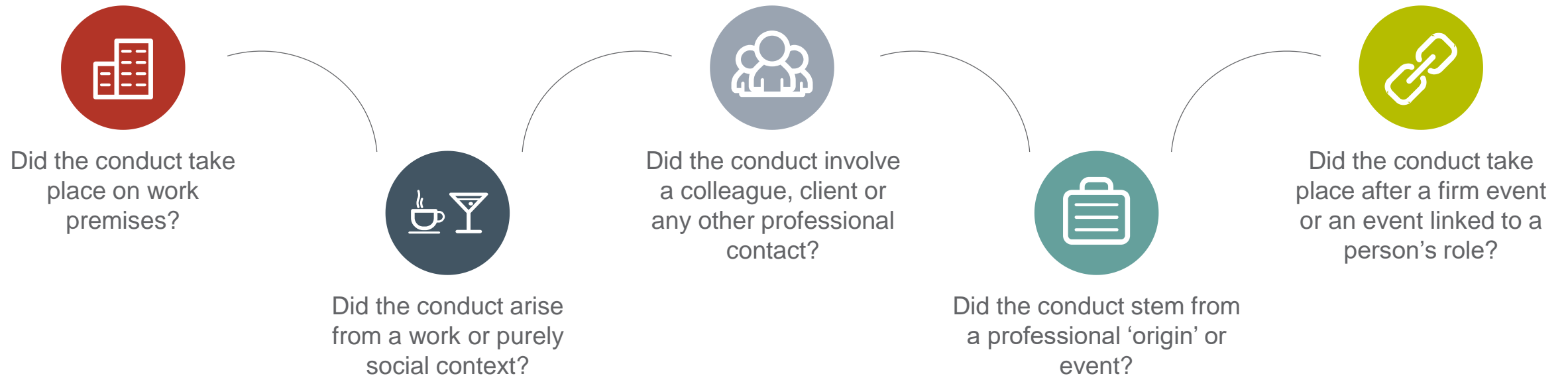


## Does the Code of Conduct even apply?

The test for assessing the scope of the Code of Conduct links back to a person's professional role and responsibilities, but many grey areas remain (especially in relation to non-financial misconduct).

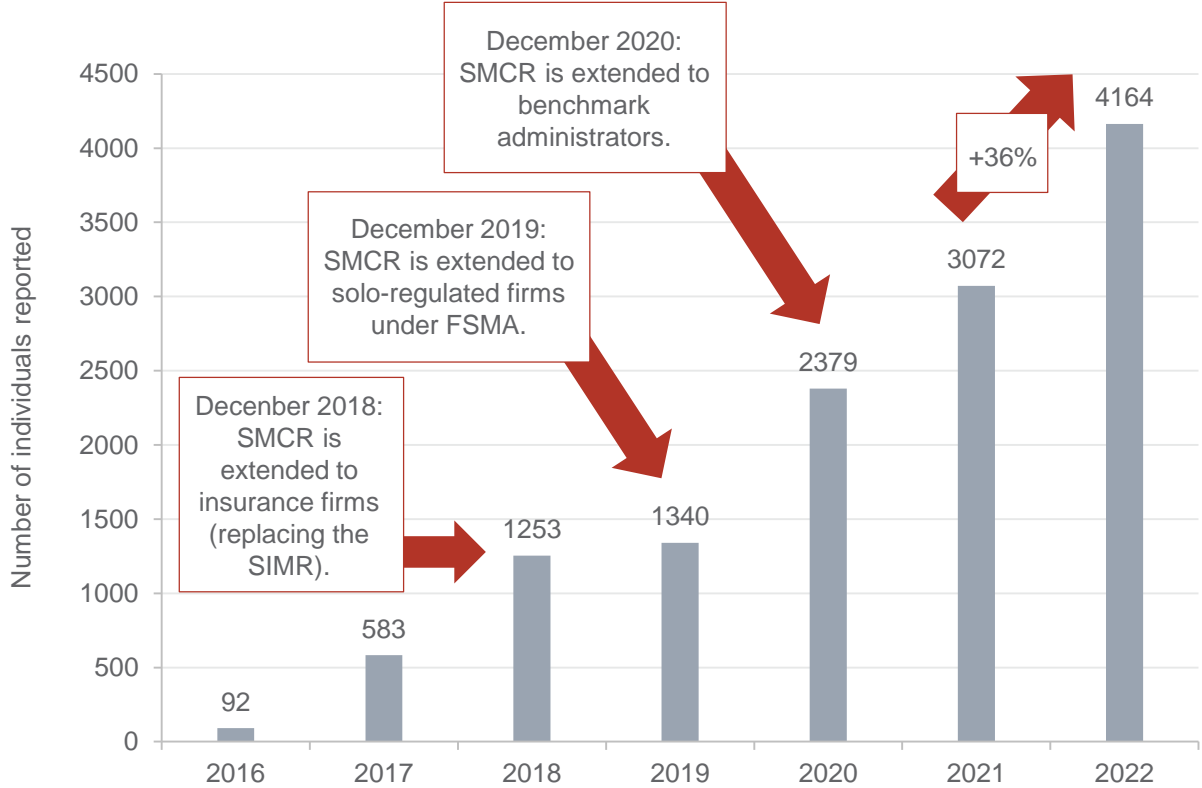
# When is an individual's conduct sufficiently proximate to their role to attract potential regulatory consequences?

The line between an individual's private and professional life is clearly blurred in some circumstances, making the process of deciding whether conduct constitutes a regulatory matter more challenging. However, the closer any conduct touches on the individual's role and responsibilities for a regulated firm, or reflects how they may behave in a professional context, the more likely it is that the conduct may fall within the scope of the FCA or PRA Code of Conduct, or be something that could impact their fitness and propriety.



# The number of individuals reported to the FCA for breaching the Code of Conduct increased by 36% in the last year alone

Of the firms required to submit REP0008s to the FCA, the vast majority had a ‘nil return’ and no breaches of the Code of Conduct to report. The 4,164 breaches from 2022 were reported by just 769 firms (representing only 1.8% of all firms that were required to submit REP0008s during 2022).



### Key themes in relation to firms’ assessments of breaches of the FCA and PRA Code of Conduct

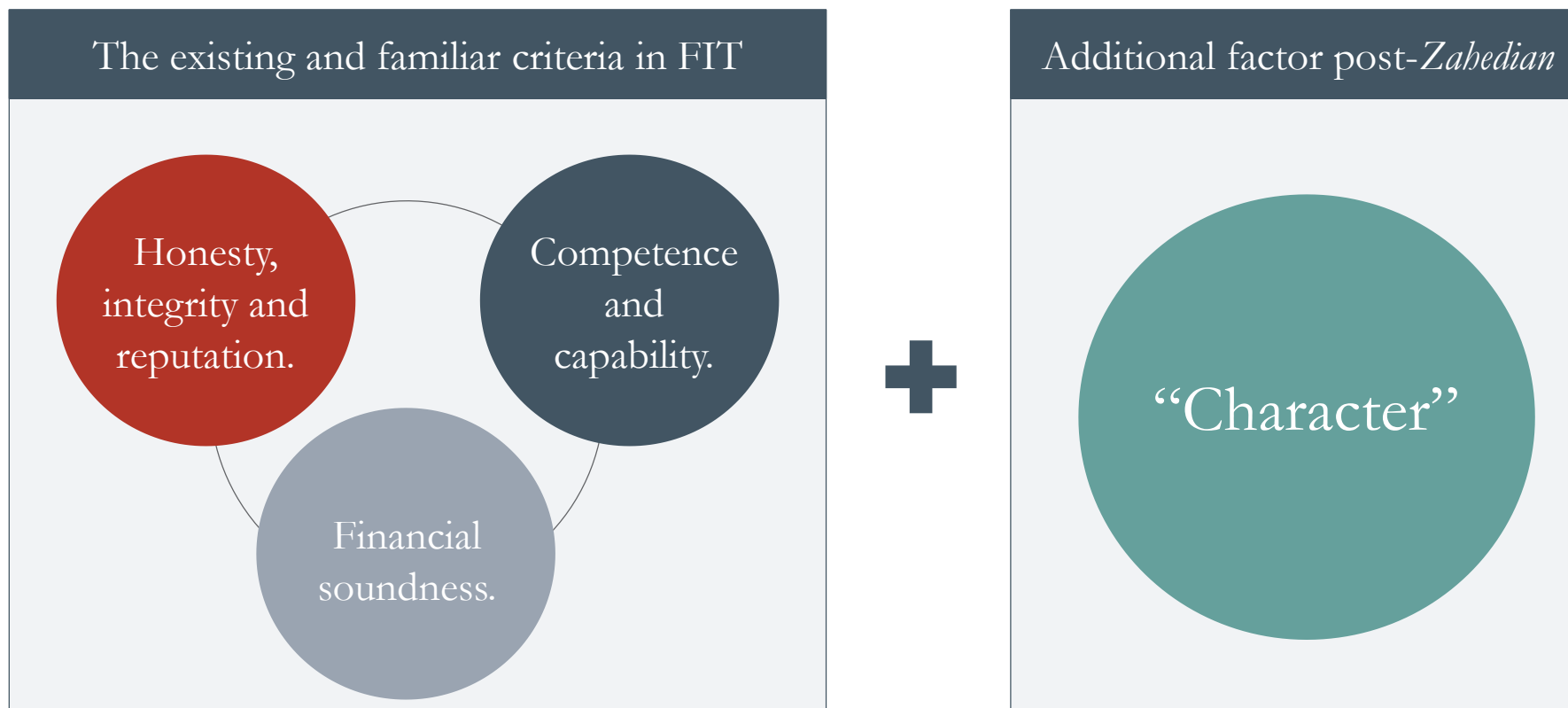
- Continued regulatory scrutiny of firms’ decisions in relation to breaches of the Code of Conduct, especially in borderline cases.
- Regulatory scrutiny of firms that do not consider (or cannot show that they have considered) potential Code of Conduct breaches.
- Clear regulatory expectation that, where possible, firms will assess breaches of the Code of Conduct for former employees.
- Employees who are found to have breached the Code of Conduct are becoming more litigious and challenging firms’ findings.

Sources: Freedom of Information Act requests (as at 28 March 2022) | Allen & Overy research | Data shows the number of individuals reported to the FCA using Rep0008 (so excluding Senior Managers) for breaching the Individual Conduct Rules. Some individuals breached multiple Individual Conduct Rules.



# Non-financial misconduct: A person’s “character” – the missing link when it comes to fitness and propriety?

In an apparent move to cut across the (unhelpful) Upper Tribunal judgment in *Jon Frensham v the FCA*, the FCA took a noticeably different approach in its latest case relating to non-financial misconduct (*Zahedian*) by focusing on an individual’s “character”.



“Those authorised to provide financial services are required to meet and maintain high standards of character, fitness and properness.

These were serious, violent criminal offences reflecting on Mr Zahedian’s character and justifying the finding that he is not a person to be working in financial services.

The FCA will continue to uphold high standards of character and conduct for those working in financial services”.

Mark Steward (Director of Enforcement and Market Oversight) on the FCA’s decision to impose a prohibition order on Mr Zahedian

# Assessing the seriousness of non-financial misconduct

Post-*Zabedian* the FCA clearly considers that the severity of an individual's conduct may be so serious that, even if there is no direct link to their role or workplace for a regulated firm, it is still capable of impacting their fitness and propriety. Factors that firms should take into account when assessing seriousness are not limited to the conduct itself, or the circumstances in which it occurred, but also the impact of conduct on a person's character, such as:



**Criminality:** Whether the conduct amounts to a criminal offence (regardless of whether it is prosecuted). But not all criminal offences will result in an individual lacking fitness and propriety.



**Specific aggravating factors:** Whether the misconduct involved violence, exploitation, threats, malice, coercion, pressure, manipulation, victimisation, intimidation, influence or breach of privacy.



**Frequency:** Whether the misconduct was repeated. The frequency of misconduct can indicate a pattern and impact on its seriousness. For example, did the conduct persist despite warnings or feedback to stop?



**Targets:** Whether the misconduct was directed at a junior employee, more than one individual or an individual who is considered to be vulnerable (either due to their own characteristics, or due to their relationship with the accused).



**Awareness:** Whether the individual who is alleged to have engaged in the misconduct was aware, or ought to have been aware, that their conduct was unwelcome or inappropriate.



**Pre-meditation:** Whether the misconduct was spontaneous or planned. A pattern of misconduct may not only be a relevant factor when it comes to assessing seriousness, but may also undermine a defence of spontaneity.

# Regulatory focus on firms' approaches to handling and investigating non-financial misconduct and senior management attitudes

Investigating allegations of non-financial misconduct can be challenging, and sometimes even more challenging than investigating allegations of financial misconduct. That said, there are some clear parameters that firms and their advisers need to keep in mind in these kind of investigations.

Senior management being seen to “turn a blind eye” to poor personal misconduct.

Shying away from investigating non-financial misconduct, or instigating disciplinary processes.

Failure to adequately protect employees who raise concerns from retaliation or victimisation.



Failing to investigate allegations of non-financial misconduct (properly or at all).

Inappropriate use of settlement agreements to avoid taking action against implicated employees.

Senior management participation in or tolerance of inappropriate personal conduct (including at work social events).

# Non-financial misconduct in an enforcement perspective: More standalone cases expected, but what else?

## Non-financial misconduct findings “through the backdoor”

Likely to see issues around non-financial misconduct forming part of regulators’ root cause analysis of more “traditional” regulatory shortcomings. For example:

The committee did not operate efficiently due to certain members having overbearing management styles, which prevented effective challenge and debate from taking place.

The Senior Manager was known to have an oppressive management style, meaning that their team were afraid to escalate issues (even material issues) to them, out of fear for their reaction.

The senior members of the team actively discriminated against certain employees during recruitment, promotion and remuneration processes. This led to a lack of diversity at senior levels in the team.

The team leader was known to shout colleagues who dared to ask questions and blamed them for jeopardising the team’s ability to meet its targets. Colleagues just kept quiet if they had questions or concerns.

## Further guidance expected

- The FCA has stated that further guidance will be produced about non-financial misconduct.
- But likely to focus on quite narrow circumstances, involving violence and harassment outside the workplace, and the impact this may have on a person’s character.

## Scrutiny of firms’ internal investigations

- Investigations already scrutinised closely by the FCA in many cases.
- Likely to continue and may feature in enforcement findings in the future (most likely coupled with issues around a firm’s whistleblowing controls).

# Regulatory references: The growing pains continue

After the dust has settled on processes for handling instances of employee misconduct, regulatory references continue to pose a range of challenges for firms.

## Disciplinary action

Does not only include written warnings and dismissal, also includes remuneration adjustments (malus and clawback). But not necessarily other types of remuneration decision.

## Question G

Continued debate and different approaches taken across the market in terms of how inclusive to be in responses to Question G (the “catch-all” question in regulatory references).

## Disclosing sensitive issues

Non-financial misconduct issues can be difficult to describe in regulatory references and special care must be taken. Issues relating to potentially anti-competitive conduct can also pose challenges.



## Resignations

Need to adapt process for preparing and drafting of a regulatory reference if an investigation cannot be completed due to the subject resigning. Does not remove the need to provide an impaired reference.

## Passage of time

Difficult decisions about whether to include conduct that occurred 4-6 years ago in response to Question G due to the time that has passed (especially if the employee was not dismissed).

## Right to comment

Trend of providing individuals with a further right to comment on the drafting of a regulatory reference before it is provided to a third party, even if they had a similar opportunity at the time of an investigation / disciplinary process.



# Horizon scanning



# What can we expect for the remainder of 2023 and beyond?

Review of legislative and regulatory frameworks for the SMCR as part of the Edinburgh Reforms.

Implementation of the Individual Accountability Framework in Ireland – due 2023.

Other jurisdictions getting ahead of the UK when it comes to enforcement action against individuals.



Publication of the FCA's proposed rules on diversity and inclusion in the financial services industry.

Financial Accountability Regime to replace and expand on existing regime in Australia.

# Questions?

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