

SENIOR MANAGERS' SURVIVAL GUIDE
UNDERSTANDING AND MANAGING YOUR
PERSONAL REGULATORY EXPOSURE





This guide contains practical guidance on what the regime change means for senior managers and the steps that you need to take to protect yourself.



Survival guide for SMF holders at banks

On 7 March 2016, the Senior Managers Regime came into force, introducing a new approach to the regulation of individuals working at banks and PRA-authorised investment firms. The political driver for this new regime is to “strengthen accountability in banking”, by making it easier for regulators to discipline individuals for regulatory failures in firms. However, the simplicity of that single intention has not translated into its implementation.

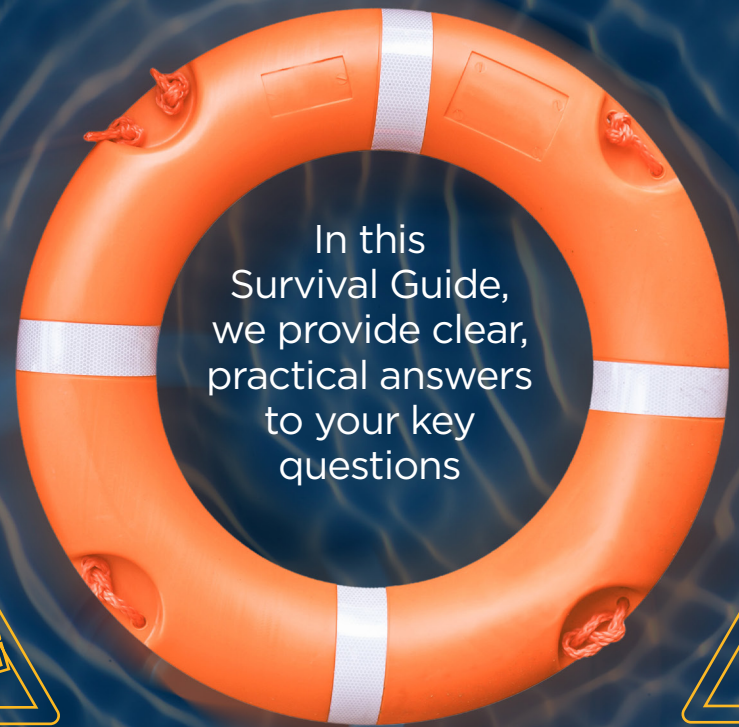
Instead, there is a huge amount of confusion surrounding the regime, caused by the vast quantity of documents published by the regulators and fuelled by a certain amount of scaremongering by some commentators. What has been lacking is practical guidance on what the regime change means for senior managers and the steps that you need to take to protect yourself from unnecessary regulatory risk.

That is where this guide comes in - it offers clear practical advice to SMF holders and answers some of the key questions we are often asked. I hope you find it useful. If you have any other questions or would like to discuss your position, please feel free to contact me or any of the team listed on the contact pages at the back.

A handwritten signature in red ink that reads "Polly".

Polly James
Financial Regulation Group





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Who is covered by the Senior Managers Regime?



The PRA and the FCA have each specified a list of functions that they have designated as Senior Management Functions (SMFs), and they will be responsible for pre-approving people to perform them. The combined list of those functions is set out below:

Key:

- ✓ SMFs specified for UK-incorporated banks
- ✓ SMFs specified for UK branches of EEA banks
- ✓ SMFs specified for UK branches of non-EEA banks

SMFs

Executives

- ✓ Chief Executive function, SMF 1 (PRA)
- ✓ Chief Finance function, SMF 2 (PRA)
- ✓ Executive Director, SMF 3 (FCA)
- ✓ Chief Risk function, SMF 4 (PRA)
- ✓ Head of Internal Audit, SMF 5 (PRA)
- ✓ Head of key business area, SMF 6 (PRA)
- ✓ Group Entity Senior Manager, SMF 7 (PRA)
- ✓ Credit Union Manager, SMF 8 (small credit unions only) (PRA)
- ✓ Compliance Oversight, SMF 16 (FCA)
- ✓ Money Laundering Reporting, SMF 17 (FCA)
- ✓ Other Overall Responsibility function, SMF 18 (FCA)
- ✓ Head of Overseas Branch, SMF 19 (PRA)
- ✓ EEA Branch Senior Manager, SMF 21 (FCA)
- ✓ Other Local Responsibility function, SMF 22 (FCA)

Non-Executives

- ✓ Chairman, SMF 9 (PRA)
- ✓ Chair of Risk Committee, SMF 10 (PRA)
- ✓ Chair of Audit Committee, SMF 11 (PRA)
- ✓ Chair of Remuneration Committee, SMF 12 (PRA)
- ✓ Chair of Nominations Committee, SMF 13 (FCA)
- ✓ Senior Independent Director, SMF 14 (PRA)

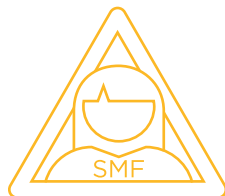
I'm a Senior Management Function (SMF) holder - now what?

From the day that you become a SMF holder, you are accountable to the regulators, not only for the standard of your own behaviour, but also for effectively managing risks in the area of the business for which you are responsible.

You also take on a personal regulatory duty, which the regulators term the "duty of responsibility", to take reasonable steps to ensure that your area of the business complies with all relevant regulatory requirements.

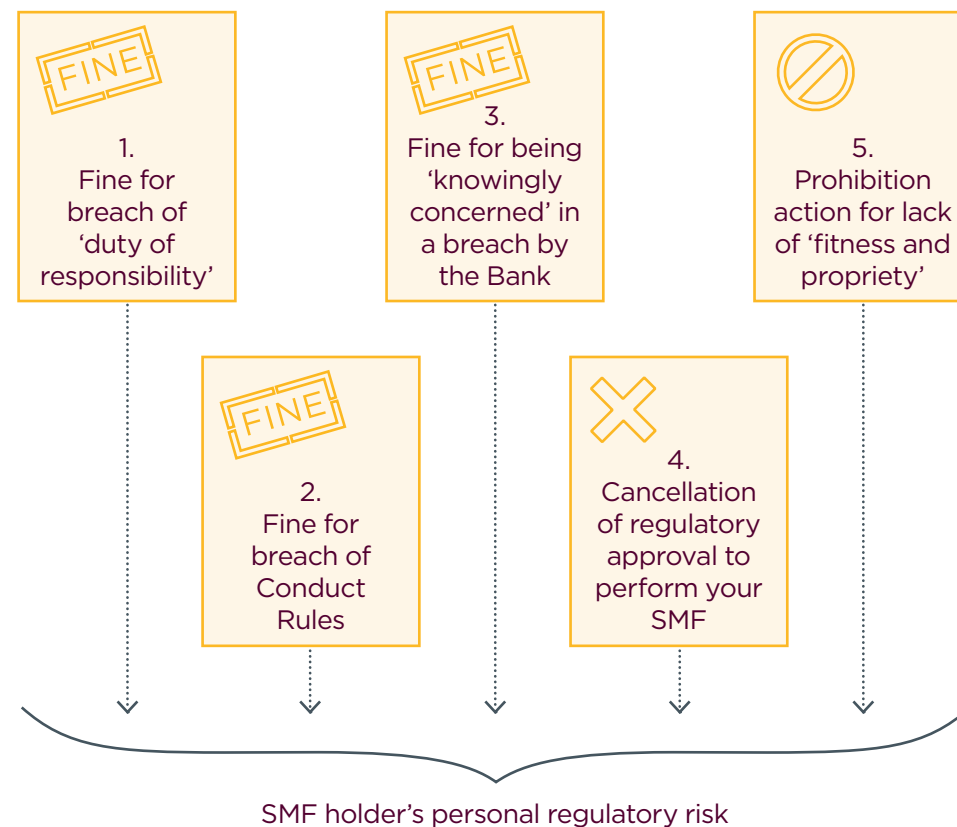
It is vitally important that you understand what, in practical terms, your new duties require of you. However, you won't find that type of practical information anywhere in the regulatory rulebook.


The purpose of this Guide is to plug that gap, in order to help you to avoid taking on excessive personal regulatory risk.



It is vitally important that you understand what, in practical terms, your new duties require of you.


What risks do I face as a result of being an SMF holder?




 **1. Fine for breach of 'duty of responsibility'**
 Your first risk category is the risk of disciplinary action, leading to a fine, if


- (a) a regulatory breach occurs in the area of the business for which you are responsible, and
- (b) the regulators can show that you did not take "such steps as a person in your position could reasonably be expected to take" to avoid that breach from occurring.


The area of the business for which you are responsible will be set out in your Statement of Responsibility document, which your firm will have submitted to the regulators. You now owe what is known as a "duty of responsibility" for that area of the business.

 **2. Fine for breach of Conduct Rules**
 Second, you could be fined for breaching one of the two sets of Conduct Rules that apply to you. As we explain on pages 10 and 11, some of these Conduct Rules are more onerous than they look.

 **3. 'Knowingly concerned' liability**
 Third, you could be fined for being 'knowingly concerned' in a breach of regulatory rules by the Bank, in any area of its business. To be 'knowingly concerned', it is necessary for you to have knowledge about the facts that gave rise to the breach, but you do not need to have known that those facts amounted to a regulatory breach.

“
 The 'fit and proper' test is concerned with three core factors: your integrity, your competence and your financial soundness.”

 **4. Variation / cancellation of approval**
 Fourth, the regulators can cancel or vary your approval to perform your SMF function, if necessary without notice. Without that approval, you would be unable to continue in your role.

 **5. Prohibition action**
 Finally, the regulators can take action to prohibit you from working in financial services - either a blanket ban or a ban on working in senior positions - if they can prove that you are not 'fit and proper' to do so. The 'fit and proper' test is concerned with three core factors: your honesty and integrity; your competence and capability; and your financial soundness.

In practice, when the regulators bring disciplinary action against individuals in senior management positions within banks, they usually seek to impose both a fine and a prohibition order - whilst the legal bases for these are separate, they are not mutually exclusive.

“
 No matter how large your firm's compliance function, the responsibility for regulatory compliance in your area lies with you.”

The Conduct Rules - understanding the hidden meanings

Below is a combined list of the Conduct Rules that the PRA and the FCA have made. You will see that there is significant overlap between the regulators' sets of Conduct Rules. All of these rules apply to you as an SMF holder.



RULE	
FCA1/PRA1	Act with integrity.
FCA2/PRA2	Act with due skill, care and diligence.
FCA3/PRA3	Be open and co-operative with the FCA, the PRA and other regulators.
FCA4	Pay due regard to the interests of customers and treat them fairly.
FCA5	Observe proper standards of market conduct.
SM1	Take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
SM2	Take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant regulatory requirements.
SM3	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.
SM4	Disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

What do the Conduct Rules require of me in practice?

The first five Conduct Rules in the table (which apply to almost all employees of banks and PRA-authorized investment firms) are reasonably self-explanatory.

However, it is much less obvious what is required of you under the Senior Manager Conduct Rules (SM1-4 in the table). On page 12 we offer some practical suggestions to help you to work out what you need to do:

- to satisfy yourself that you are complying with these rules; and
- to be able to demonstrate to a regulator that you have complied with them, in the event that your firm runs into regulatory difficulties.



You need to be able to demonstrate that you have complied, if your firm runs into regulatory difficulties.



What needs to be done in the first two months?

Conducting an effective 'initial assessment' of the design and operation for your business area

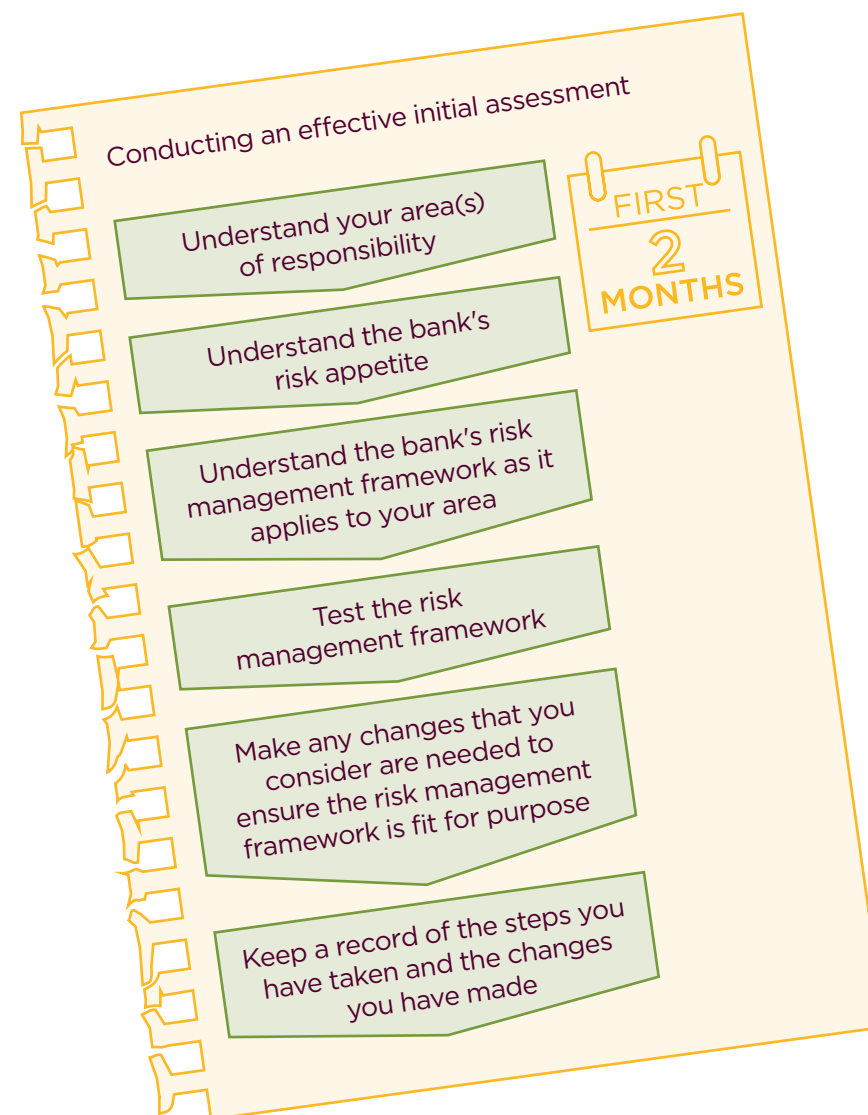
On coming into a new SMF role, the regulators expect you to carry out an independent, thorough assessment of the risk management framework in place for the area of the business for which you are responsible. This duty is nowhere to be found in the rulebook, but comes from case law. In particular, the FSA's case against John Pottage, former CEO of UBS's Wealth Management Division, for failing to comply with his personal regulatory duty to take reasonable steps to ensure that UBS complied with regulatory requirements.

The FSA ultimately lost its case against Mr Pottage in 2012, but nevertheless the Tribunal held that Mr Pottage had a regulatory duty to carry out an initial assessment of the firm's risk management framework within two months of taking up his role.

The same regulatory duty applies to you in respect of the area of your firm's business that you are responsible for. The purpose of this exercise is to satisfy yourself that a robust process is in place to identify, assess and manage each of the various material risks that your area of the business is exposed to.



You need to carry out an independent, thorough assessment of the risk management framework in your area of the business.



Initial assessment guidance notes

We have produced a series of detailed guidance notes on the areas that need to be covered in an SMF's initial assessment. Please do get in touch if you'd like us to send you a copy of the one most relevant to your sector and role.



Understand your area of responsibility

Step 1 is to make sure you are clear about which area of the firm you are responsible for. Your statement of responsibility will set that out. Make sure you have a copy to hand and that you are still happy it remains an accurate description of your role. If it isn't, it is important that you get your firm to update it and send the updated version to the regulators.

Understand the bank's risk appetite

It is crucial to make sure you have properly understood the firm's stated risk appetite, so that you can then assess whether the risk management framework properly reflects the tolerance to risk that the firm's governing body has set.

Understand the bank's risk management framework as it applies to your area

Next, you need to understand the firm's organisational structure and risk management framework for your area of the business. This will involve arranging meetings with the people in the business who have the best knowledge of how your area was managed before your appointment (ideally including your predecessor in the role), and also with Compliance, Risk Management, Internal Audit and HR.

Test the risk management framework

You then need to test the effectiveness of the risk management framework that is currently in place. Is it fit for purpose? Ask probing questions of your colleagues about:

- the process followed for identification and assessment of risks in the relevant part of the business
- the systems and controls – do they properly track and adequately manage the risks identified?
- how the framework has responded when issues have arisen in the past

In addition you should assess the adequacy of the management information you are provided with, to keep yourself properly informed about the activities of your part of the business and the risks to which the bank is exposed.

Finally, you should assess the quality and competence of those who report directly to you, to ensure you are confident that they are appropriate people to delegate activities to.

Make any changes that you consider are needed to ensure the risk management framework and organisation structure are fit for purpose

If, on testing the risk management framework, you discover that there are areas that are not as robust as they should be, you must take action to improve them within a reasonable timeframe. Similarly, if management information systems are inadequate in any way, or you have concerns about the competence of your direct reports, you should take action now.

Keep a record of the steps you have taken and the changes you have made

Finally, as far as the regulators are concerned, if you haven't documented it, you haven't done it – so do keep careful records of all the steps you have taken to complete your initial assessment, so that you can prove it later on if you need to.

Your assessment needs to be independent and it needs to be your own – you can, of course, get people to help you, but you must remain centrally involved. You certainly should not outsource it completely.



Where an issue raises significant concerns, act clearly and decisively.



Fact and fiction – mind the gap

To understand your personal position under the regulatory system, it is important to be aware of how the regulators view your new management responsibilities. In particular:



The control environment

Although the control environment will already have been in place when you assumed the role, you are treated under the regulatory system as being personally responsible for taking reasonable steps to ensure that the relevant part of the business is controlled effectively.



Delegated activities

When you assume the role, there will already be a large number of individuals engaged to carry out activities within the relevant part of the business. Those individuals are treated under the regulatory system as people to whom you personally are delegating activities and you must be satisfied that they are competent. This is the case whether the individuals are other employees of the firm or external contractors to whom activities have been outsourced.



Information reporting

Management information and reporting structures will already be in place to keep you informed of developments within the relevant part of the business. However, you are personally responsible under the regulatory system for the ways in which information is reported to you in your part of the business. You must ensure that the management information you receive enables you to monitor the business and manage its risks effectively.

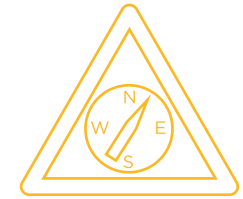


The risk management framework

Although the risk management framework (as it applies to the relevant part of the business) and the corresponding systems and controls will already be in place when you assume the role, you are viewed under the regulatory system as being personally responsible for its design and effectiveness.

As you can see, understanding the regulators' approach is crucial to understanding what will be expected of you under the Senior Manager Conduct Rules.

How do I meet the standard on an ongoing basis?



Although conducting an effective initial assessment of the risk management framework for your business area within two months of coming into your role is an important first step in complying with your personal duties under the Senior Manager Conduct Rules, it is equally important that you keep that framework under review.

This is because your duty to ensure that your business area is managing risk effectively is an ongoing duty.

How, in practice, can you fulfil this duty?

Your ongoing duties under the Senior Manager Conduct Rules may be divided into reactive and proactive duties.

If an issue is discovered in your area of the business, your duties as an SMF holder include reacting appropriately to that discovery, by assessing how the issue has been able to occur within the existing risk management framework (and how such issues can be prevented from happening again). See further details on page 19 - "What should I do when a problem occurs?"

However, as an SMF holder, you also have proactive duties to review and update the risk management framework on an ongoing basis. These duties exist even if you are not aware of any issues and you therefore have no reason to think that the risk management framework is deficient.

Periodic assessments of the risk management framework for your business area are the best way either to satisfy yourself that the risk management framework is still operating effectively; or alternatively to alert you to anything that is not working well.

What should I include in my periodic reassessments of the risk management framework as it applies to my business area?

- First, check that the organisational structure is operating effectively. Are reporting lines working well? Are important matters being escalated to you quickly enough?
- Second, check that risks are being identified effectively within the framework. Has a particular risk been notified to you late, having come in under the radar?
- Third, review the competence and capability of your direct reports. Do not rely solely on their annual appraisals – ask yourself, am I happy that they are effective in supporting me to identify and manage the risks in my area of the business?
- Fourth, assess whether the management information you are getting remains appropriate to monitor the business and remain confident that its risks are being managed effectively – neither too much information, nor too little.



You also have proactive duties to review and update the risk management framework.



Practical tips

As a rule of thumb, we advise SMF holders to carry out a periodic review of the risk management framework as it applies to their business area on an annual basis. We often advise using recurring annual appointments in your diary to remind you to complete these.

However, if there is a major development in relation to your business area (for example, a merger or acquisition or a significant change in strategy) then it may be sensible to undertake a fresh assessment ahead of your annual review, to ensure that risks are still being managed effectively following that major development.

It is very important to make written records of the reviews that you are conducting, so that you will have proof of the steps that you have taken, if you ever need it.

What should I do when a problem occurs?

If you are notified of a potential regulatory breach in the area of the business for which you are responsible, your priority is to find out, as quickly as possible, what has actually happened, how it happened and what the regulatory consequences are.

You also need to keep in mind your duty under Senior Manager Conduct Rule 4 to disclose to the regulators anything of which they would reasonably expect notice. It is a fair rule of thumb that anything that amounts to a material breach of any regulatory rule will be something that the regulators would expect notice of. Remember that, for breaches occurring in your area of the business, this is a personal duty upon you to ensure a notification is made – not the CEO, and not the Compliance or Risk Departments.

You are likely to need to carry out an internal investigation, which should be done in two phases: first, an urgent, high level review to establish whether a regulatory notification needs to be made; and second, a thorough review to establish exactly what has happened and what root causes there may have been for it.

As well as investigating the specific issue that has presented itself, it is important to step back and think about what the incident tells you about the risk management framework for your area of the business, and that for the wider firm.

- Could there be a systemic weakness with your risk management framework that may allow it to happen again?
- If so, what do you need to do to fix that?
- Could the same root causes exist in other areas of the business and give rise to similar issues there?

As always, take careful steps to document the review you have undertaken and its conclusions, and then to ensure that you follow up on any action points identified.

If you are unsure about what your personal regulatory duties require of you in the context of a particular issue that has come to light, feel free to call any of us listed on the back pages of this Guide – we'd be very happy to help.



It is important to step back and think about what the incident tells you about the risk management framework for your area.



Who should I call if I need a lawyer to advise me on my personal position?



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Specialises in advising financial institutions and their senior management in regulatory investigations and related litigation. Has experience of working for the regulator, having spent over a year on secondment to the FCA's Enforcement & Financial Crime Division.

Getting in touch

When you need a practical legal solution for your next business opportunity or challenge, please get in touch.

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