PRA AND FCA PROPOSALS ON INDIVIDUAL ACCOUNTABILITY AND REMUNERATION

The willingness of financial regulators to get tough with individuals has never been greater. The financial crisis and high profile cases of misconduct have contributed to a sense of cultural and behavioural problems in the financial services industry that regulators want to be seen to be tackling. However, despite increasing levels of enforcement action against firms, the UK's Financial Conduct Authority (the FCA) and Prudential Regulation Authority (the PRA) have relatively modest records of enforcement action against individuals arising from high profile misconduct or mis-management.

At the end of July 2014, the FCA and the PRA published two joint consultation papers titled 'Strengthening accountability in banking: a new regulatory framework for individuals'[1] and 'Strengthening the alignment of risk and reward: new remuneration rules'[2]. The consultations built on the foundations laid in the Financial Services (Banking Reform) Act 2013 to look towards a complete overhaul of the regulatory regime for individuals and further limitations on variable pay.

The FCA and the PRA published draft rules in December 2014[3] and further clarifications in February 2015[4]. Near final rules were published by the FCA on March, 16 2015[5]. On the same day, the FCA and PRA issued a joint consultation paper on applying the senior managers regime to UK branches of foreign banks[6]. On March, 23 2015, the PRA also published a policy statement titled, 'Strengthening individual accountability in banking and insurance', and setting out certain finalized rules. The PRA expects to publish a further set of finalized rules later in 2015[7]. The UK government has

[1] PRA CP14/14, FCA CP14/13

[2] PRA CP15/14, FCA CP14/14

[3] PRA CP28/14, FCA CP14/31

[4] PRA CP7/15, FCA CP15/5

[5] FCA CP15/9

[6] PRA CP9/15, FCA CP 15/10

[7] PRA PS3/15

announced that the new regime will take effect from March, 7 2016. This briefing considers the changes and their implications for the industry.

Overview of the Proposed Regulatory Framework for Individuals

The proposals envisage three layers of individual accountability, underpinned by a new set of Conduct Rules, replacing the existing Statements of Principle for Approved Persons. The Statements of Principle presently set the standards of conduct expected of Approved Persons who perform certain "controlled functions" in regulated financial institutions. The new regime will introduce:

1. a **Senior Managers Regime**, under which members of a firm's senior management will require pre-approval from the FCA and, in some circumstances, the PRA. The Conduct Rules, including some rules specific to Senior Managers, will apply to such individuals;

2. a **Certification Regime** requiring firms to certify on at least an annual basis the fitness and propriety of material risk takers, some customer-facing employees, supervisors of other Certified Persons and other significant influence roles such as benchmark submitters. The Conduct Rules will apply to Certified Persons; and

3. the FCA will apply the Conduct Rules to **all other employees not subject to regulatory pre-approval**, except those in purely ancillary roles.

The proposals represent a significant widening of the scope of individual accountability for banks, building societies, credit unions and PRA-designated investment firms. At present, regulatory jurisdiction over individuals is limited to approved persons who are required to comply with the Statements of Principle for Approved Persons. The regulators' proposals would replace the existing regime entirely and extend the regulatory ambit dramatically.

These reforms are bolstered by the FCA's commitment to bring enforcement action against senior managers where they fail to meet the standards required. A proposed amendment to the Enforcement Guide states: "*The FCA believes that deterrence will most effectively be achieved by bringing home to such individuals the consequences of their actions*".

Senior Managers

The regulators have proposed a list of 17 Senior Management Functions that will require pre-approval from either the PRA or the FCA. Notably, the FCA has stated that the regime will not apply to non-executive directors that do not chair certain specified sub-committees of the board. Where there is overlap between roles and a firm is seeking approval from the PRA for a candidate to perform a PRA controlled function and the intention is that the candidate will also perform what would otherwise be an FCA governed function after PRA approval is granted, generally only PRA approval will be required. There are, however, circumstances where FCA approval would also be required, such as where an individual takes up an FCA governed role and later takes an additional PRA governed role.

The Senior Management Functions are:

Senior Management Function		Approval generally required
SMF1	Chief Executive function	PRA
SMF2	Chief Finance function	PRA
SMF3	Executive Director	FCA
SMF4	Chief Risk function	PRA
SMF5	Head of Internal Audit	PRA
SMF6	Head of key business area	PRA
SMF7	Group Entity Senior Manager	PRA
SMF8	Credit Union SMF (small credit unions only)	PRA
SMF9	Chairman	PRA
SMF10	Chair of the Risk Committee	PRA
SMF11	Chair of the Audit Committee	PRA
SMF12	Chair of the Remuneration Committee	PRA
SMF13	Chair of the Nominations Committee	FCA
SMF14	Senior Independent Director	PRA
SMF16[8]	Compliance Officer	FCA
SMF17	Money Laundering Reporting	FCA
SMF18	Significant Responsibility SMF	FCA

Whilst most of the Senior Management Functions are self-explanatory, two in particular require further explanation:

- the proposed **head of key business area** function will apply to a person who manages an area with gross total assets of £10bn or more which accounts for 20% or more of the gross revenue of the firm or its group; and

[8] The numbering is not consecutive because the FCA removed Non-Executive Directors from the scope of the rules in February 2015. The Non-Executive Director role was originally proposed as a regulated Senior Management Function. We expect the numbering will be revised before final rules are published.

- the **significant responsibility** function will apply to those to whom the board has delegated overall responsibility for a key function or identified risk and they are primarily responsible for reporting to the board in respect of that function.

The regulators have proposed that any individual currently approved to perform a Significant Influence Function under the current regime, who will be performing a corresponding Senior Management Function role under the new regime, be eligible to be grandfathered into that new role. Firms must submit their grandfathering notifications by February, 8 2016.

It should be noted that the proposals require an increased level of granularity in mapping senior management responsibilities. In particular, the PRA has proposed a list of 20 responsibilities to be allocated among the PRA-approved Senior Managers, ranging from overseeing the independence and integrity of key control functions such as internal audit, compliance and risk, to leading the development of the firm's culture and standards.

Firms will be required to map out their governance and management arrangements in a single document referred to as a 'Responsibilities Map'. The FCA has prescribed a list of Senior Management Responsibilities, which is non-exhaustive but is intended to be indicative of the main business areas and management functions of a firm, in order to help firms prepare their responsibilities maps. Firms will be expected to allocate each of the prescribed responsibilities to one or more Senior Management Function holders.

Firms will also be required to submit a Statement of Responsibilities when applying for approval for a Senior Management Function holder, setting out the aspects of the affairs of the firm concerned which it is intended the holder will be responsible for managing.

The implications for those in senior management roles are significant and indicative of the broader move towards a greater level of individual and particularly senior management accountability for regulatory failings by firms. The stricter requirements on mapping out and allocating responsibilities will be backed by a 'presumption of responsibility' under which Senior Managers will have to prove that they took reasonable steps to prevent or remedy regulatory breaches by the firm in their areas of responsibility in order to avoid personal liability. The FCA is consulting further on the circumstances in which it would apply the presumption of responsibility, how it would be applied and how a Senior Manager can rebut it. It has proposed that it should have regard to obligations set out in the Companies Act 2006, the UK Corporate Governance Code and the Model Code (where applicable) in determining whether a Senior Manager has taken such reasonable steps.

Moreover, section 36 Financial Services (Banking Reform) Act 2013 will introduce a new criminal offence where a Senior Manager takes a decision, or fails to take such steps as they can to prevent such a decision, that causes an institution to fail. In parallel with the criminal regime, the FCA may also impose financial penalties in relation to a breach of the Conduct Rules, or for being knowingly concerned in an entity's breach of a regulatory requirement. The focus on senior management taking responsibility for their decisions and for their oversight and management of the firm is clear.

Senior Managers will also be affected by the remuneration proposals. The regulators propose to extend the minimum deferral period (currently three to five years) so that awards to Senior Managers must be deferred over at least seven years, with the first vesting no earlier than three years from the date of the award. The award may not vest faster than pro rata over years three to seven.

It is also proposed that the minimum clawback period for Senior Managers is increased from seven years to 10 years where a firm has started an internal inquiry into a potential material failure that could lead to clawback, or where a firm has been clearly notified by a regulatory authority (which could be an overseas regulator) of an investigation which the firm considers could lead to clawback.

Certified Persons

Firms will be required to take a greater degree of responsibility for the fitness and propriety of their employees. The proposals require firms to certify employees as fit and proper where they hold a 'significant harm function'. For example, staff who could pose a risk of significant harm to the firm or its customers include those who provide investment advice, execute client orders or administer benchmarks. Firms will be required to renew certifications on an annual basis.

The FCA is considering expanding the scope of the Certified Persons regime in wholesale markets, regardless of whether or not staff are in customer-facing roles or qualify as material risk takers, and may consult on any proposed changes in due course.

The forthcoming regime places the primary duty on firms, rather than regulators, taking responsibility for ensuring the fitness and propriety of employees. It will also reduce substantially the number of FCA-approved employees within a firm since individuals holding customer-facing roles will no longer require regulatory approval. The onus on assessing their suitability will instead fall on the firm. The regulators will no longer perform the level of checks and supervision on those employees who do not require regulatory pre-approval, nor will it request the same information for such individuals as under the current regime.

The two regulators take a different approach in relation to those roles requiring certification. The FCA regime applies to:

- individuals performing functions that are Significant Influence Functions under the current Approved Persons regime that would not fall within the scope of the new Senior Management Functions;

- individuals in customer-facing roles which are subject to qualification requirements, such as mortgage advisors or retail investment advisors[9]; and

- anyone who supervises or manages a Certified Person, if they are not a Senior Management Function holder.

The PRA's certification regime will apply to material risk takers: broadly persons whose actions could have a material impact on the risk profile of the firm.[10]

Material risk takers are also affected by the remuneration proposals, where it is proposed that the minimum deferral period (currently three to five years) is increased so that awards must be deferred over at least five years, with the first vesting no earlier than one year from the date of the award. The award may not vest faster than pro rata.

Fitness and Propriety

Whilst the division of responsibility between firms and regulators in respect of the fitness and propriety of employees will change, the proposals do not envisage significant changes in regulatory expectations when assessing whether a person is fit and proper. Factors such as the qualifications, training, competence and personal characteristics of employees will continue to be relevant and firms will be required to consider them when assessing a Certified Person.

Firms will be required to request references covering the previous five years of employment for any Senior Management Function or Certified Person appointment. Where a reference is provided by another regulated firm, it will need to disclose any facts that led to the previous employer concluding that the candidate breached a Conduct Rule and information on any disciplinary action relating to a breach of the Conduct Rules. The PRA has confirmed that it will not prescribe a template for references, as this could be disproportionately costly, but has directed firms to its draft

[9] The FCA will consult on extending the certification regime to all individuals involved in wholesale activities, such as traders, who perform roles that could pose "significant harm" to the firm or its customers.

[10] It is intended that the definition of 'material risk taker' is consistent with the definition in the Capital Requirements Regulation, which is based on the criteria used for remuneration purposes.

rules which set out the minimum information to be included in a reference. Firms will also be required to carry out criminal records checks on those it proposes to appoint to Senior Management Functions.

Conduct Rules

The proposed Conduct Rules will replace the existing Statements of Principle for Approved Persons. They are significantly wider in application, as the FCA will apply them not just to Senior Management Function holders and Certified Persons, but to all employees other than non-executive directors who are not Senior Managers, or ancillary staff whose role would be fundamentally the same in a non-financial services business. The FCA proposes to provide an exhaustive list of roles to which the Conduct Rules do not apply, and the proposals identify 20 such roles including cleaning staff, catering staff, personal assistants/secretaries, corporate social responsibility staff and IT helpdesk staff. The PRA will apply the Conduct Rules to all Senior Managers and to individuals within its certification regime (material risk takers).

The proposed rules are divided into two tiers: those applicable to all relevant employees and those applicable to Senior Managers only. Some of the rules will be applied by both the FCA and the PRA, and some will be applied by the FCA only. The proposed rules are:

Rule		**Applied by**
First tier – Individual Conduct Rules		
Rule 1	You must act with integrity.	PRA and FCA
Rule 2	You must act with due skill, care and diligence.	PRA and FCA
Rule 3	You must be open and cooperative with the FCA, the PRA and other regulators.	PRA and FCA
Rule 4	You must pay due regard to the interests of customer and treat them fairly.	FCA only
Rule 5	You must observe proper standards of market conduct.	FCA only
Second tier – Senior Management Conduct Rules		
SM1	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.	PRA and FCA
SM2	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.	PRA and FCA

Rule		Applied by
SM3	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.	PRA and FCA
SM4	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.	PRA and FCA

The Conduct Rules mirror the existing Statements of Principle for Approved Persons in some respects. However, two of the Conduct Rules merit particular comment:

- Rule 4, which requires individuals to pay due regard to the interests of customers and treat them fairly, mirrors the requirement imposed on firms by Principle 6 of the FCA's Principles for Businesses. However, there is no such requirement on individuals under the existing regime. This new requirement might be seen as a direct reaction to high profile mis-selling cases involving products such as payment protection insurance and interest rate hedging products; and

- SM3, requiring Senior Managers to oversee the discharge of delegated responsibility and ensure that it is delegated to an appropriate person, has no equivalent in the current regime. It is consistent with the regulators' desire to promote diligent oversight from senior management.

Although the Conduct Rules are framed as high-level principles, the FCA Draft Handbook text gives more specific guidance on the types of conduct that would breach the rules. This approach has some similarities to the existing regime, where the high-level Statements of Principle for Approved Persons are supplemented by the guidance and examples in APER 4.

Firms will be required to train employees subject to the Conduct Rules on how the rules apply to them and to notify the regulators when they aware that or suspect that a person has breached the Conduct Rules. Firms will also be required to notify the regulators if they take disciplinary action against a person in relation to a breach of the Conduct Rules.

Application to Branches of Overseas Banks

On March 16, 2015, the PRA and FCA published a joint paper on widening the scope of the regime to include UK branches of foreign banks. The regulatory authorities will be taking different approaches to their application of the regime; the PRA's regime applies exclusively to non-EEA branches, whilst the FCA, in relation to conduct of business issues, also has specific direct supervisory powers over incoming EEA branches.

In relation to non-EEA branches, the PRA proposes to require at least one individual to be approved for an additional Senior Management Function: Head of Overseas Branch. It describes this function as akin to the role of CEO of the branch. This individual will have decision-making authority over activities subject to UK regulation. In addition to this position, where there is another individual based in a different UK group entity with direct management or decision-making responsibility for the non-EEA branch, this individual will be required to obtain pre-approval as a Group Entity Senior Manager. Any individuals performing executive Senior Management Functions (which the PRA states will be functions including chief finance, chief risk and head of internal audit), will also require pre-approval.

The FCA will also introduce a new Senior Management Function: Overseas Branch Senior Manager. This position would apply to senior individuals who report to the Head of Overseas Branch, and have specific responsibility for a business area, activity or branch management function. The FCA will also require a Senior Manager to be appointed to the roles of Money Laundering Reporting Officer and Compliance Oversight of the non-EEA branch.

In relation to EEA branches, the FCA will also require a Senior Manager to be appointed to the MLRO function, and will additionally introduce a new Senior Management Function, specific to such branches: EEA Branch Senior Manager. The individual(s) appointed to this role will be responsible for the management and conduct of business of the branch.

In relation to the certification regime for UK branches of foreign firms, the PRA will use the definition of “material risk taker” to align the certification regime for non-EEA branches to the approach set out in the Remuneration Rules. The FCA intends that the scope of its certification regime for both non-EEA and EEA branches will be similar to that for UK firms, as set out above.

The PRA proposes that the same conduct rules regime that apply to UK firms would applies to those individuals in non-EEA branches performing Senior Management and PRA certification functions. The full set of the PRA’s conduct rules will therefore apply to a Senior Manager, and a narrower set to those individuals captured by the certification regime. The FCA will also apply the same regime it proposes for UK firms to both non-EEA and EEA branches. This will mean that the FCA’s conduct rules will apply to Senior Managers, those individuals caught by the certification regime and all other employees (other than ancillary staff whose role is not part of the financial services’ business of the firm).

Other Remuneration Proposals

As well as the proposals on increasing deferral periods for variable compensation paid to Senior Managers and material risk takers, and the proposals to extend clawback periods for Senior Managers, the regulators are consulting on a number of other proposals relating to remuneration.

The regulators identify the practice of firms buying out unvested bonus awards when hiring from competitors as problematic, and propose a number of options for addressing this issue: banning buy-outs, requiring firms to maintain unvested awards when an employee leaves, allowing the regulator to recover buy-outs where a former employer would have had grounds to do so and leaving the existing regime effectively unchanged by relying on clawback. The regulators have invited views on the different approaches and any alternatives.

The PRA has also proposed introducing new requirements about how firms may determine variable remuneration. The proposals would ban the use of revenue-based measures except as part of a risk-adjusted scorecard and require firms to deduct a prudential valuation adjustment figure from fair value accounting profit when using profit to determine the size of the annual bonus pool.

It is also proposed that firms are explicitly banned from paying variable remuneration to non-executive directors in relation to their non-executive roles.

Forthcoming Developments

Further guidance and information is expected from the regulators over the coming year. This includes the publication of final rules and publication of further policy and supervisory statements. Additionally, the regulators are expected to issue guidance on transitional provisions, including the practical steps necessary to make use of the grandfathering arrangements.

Consultation Papers and Policy Statements

The Consultation Papers and Policy Statements are available at:

'Strengthening accountability in banking: a new regulatory framework for individuals': http://www.fca.org.uk/your-fca/documents/consultation-papers/cp14-13

'Strengthening the alignment of risk and reward: new remuneration rules': http://www.fca.org.uk/your-fca/documents/consultation-papers/cp14-14

‘Strengthening accountability in banking: forms, consequential and transitional aspects’:
http://www.fca.org.uk/your-fca/documents/consultation-papers/cp14-31

‘Approach to non-executive directors in banking and Solvency II firms & Application of the presumption of responsibility to Senior Managers in banking firms’:
http://www.fca.org.uk/your-fca/documents/consultation-papers/cp15-05

‘Strengthening accountability in banking: a new regulatory framework for individuals – Feedback CP14/13 / PRA CP14/14 and consultation on additional guidance’:
http://www.fca.org.uk/static/documents/consultation-papers/cp15-09.pdf

‘Strengthening accountability in banking: UK branches of foreign banks’:
http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp915.pdf

‘Strengthening individual accountability in banking and insurance — responses to CP14/14 and CP26/14’:
http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps315.pdf

Further Information

If you have any questions, please feel free to contact any of your regular contacts at the firm.

Summary of Roles and Requirements

ROLE	APPROVAL	CONDUCT RULES	ENFORCED BY
• Chief Executive function • Chief Finance function • Chief Risk function • Head of Internal Audit • Head of key business area • Group Entity Senior Manager • Credit Union SMF • Chairman • Chair of the Risk Committee • Chair of the Audit Committee • Chair of the Remuneration Committee • Senior Independent Director	PRA and FCA	Rules 1, 2 and 3 SM 1, 2, 3 and 4	PRA and FCA
		Rules 4 and 5	FCA
• Executive Director • Chair of the Nominations Committee • Compliance Officer • Money Laundering Reporting • Significant Influence SMF	FCA	Rules 1, 2 and 3 SM 1, 2, 3 and 4	PRA and FCA
		Rules 4 and 5	FCA
• Material Risk Taker	None – firm must certify	Rules 1, 2 and 3	PRA and FCA
		Rules 4 and 5	FCA
• Role of a Significant Influence Function holder under the current regime • Customer-facing role requiring a qualification • Supervisor or manager of a Certified Person	None – firm must certify	Rules 1, 2, 3, 4 and 5	FCA
• All other employees except ancillary roles and non-executive directors	None	Rules 1, 2, 3, 4 and 5	FCA

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