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Individual Accountability: Extending the Senior Managers & Certification Regime to all FCA firms (CP 17/25)

Response from the Employment Lawyers Association

03 November 2017

INTRODUCTION

1) The Employment Lawyers Association ("**ELA**") is a non-political group of specialists in the field of employment law and includes those who represent claimants and respondents in courts and employment tribunals. It is not ELA's role to comment on the political or policy merits or otherwise of proposed legislation or regulation, rather it is to make observations from a legal standpoint. Accordingly in this consultation we do not address such issues. ELA's Legislative and Policy Committee consists of experienced solicitors and barristers who meet regularly for a number of purposes including to consider and respond to proposed legislation and regulations.

2) The Legislative and Policy Committee of ELA set up a sub-committee under the chairmanship of Caroline Stroud of Freshfields Bruckhaus Deringer LLP to consider and comment on the consultation paper from the Financial Conduct Authority ("**FCA**") on Individual Accountability: Extending the Senior Managers & Certification Regime (the "**Extended Regime**") to all FCA firms published in July 2017 (the "**Consultation**"). Its report is set out below. A list of the members of the sub-committee is in the Appendix.

3) Our comments are only addressed to those non-policy questions we considered it appropriate to address. Reference is made to ELA's response to the FCA and the Prudential Regulation Authority ("**PRA**") consultation on strengthening accountability in banking and insurance (PRA CP36/15 and FCA CP15/31) submitted on 7 December 2015 (the "**2015 Response**").

Executive Summary

A. We have provided comments only in relation to questions 14 and 33 of the Consultation.

B. In relation to regulatory references, we would query whether it is appropriate to extend the regulatory reference regime to all authorised firms in the way currently applied to Relevant Authorised Persons ("**RAPs**") (the "**Banking Regime**").

C. As explained in our 2015 Response and borne out in our experience of the Banking Regime, the use of a mandatory template for regulatory references will require a significant cultural change in firms' approaches to providing references; and create potential unfairness, or at least lack of clarity, of which regulators will need to be to be mindful particularly where there has been no disciplinary process in which an employee has had an opportunity to comment on any allegations. We have made a number of suggestions in this regard below, some of which apply equally to the Banking Regime as well as to proposals for the Extended Regime.

D. In relation to the new prescribed responsibility for conduct rules, we suggest that the proposal as regards reporting should be reformulated.

E. References are made in this response to the relevant rules in the FCA Handbook for ease. References to FSMA are to the Financial Services and Markets Act 2000 (as amended).

Question 14: Do you agree with our proposed requirement of regulatory references? If not, please explain why.

1) Our members have experience of the practical difficulties faced by firms under the Banking Regime in complying with the regulatory reference regime, and we query whether it is appropriate given these difficulties to extend the regulatory reference regime in exactly the same way to all authorised firms. We have set out below some particular issues which we anticipate would arise if the regulatory reference regime was adopted for the Extended Regime in the same format as applies under the Banking Regime. We have also taken this opportunity to suggest some areas where the FCA could provide greater clarity on regulatory references under the Banking Regime as well as the Extended Regime (should the regime be rolled out, as proposed).

Application to all firms on the same basis

2) In our view, the planned application of the regulatory reference regime to all firms (not only enhanced but also core and limited scope firms) represents a challenge which may not be proportionate to the regulators' aims. We have outlined below various issues faced by firms under the Banking Regime in connection with regulatory references.

3) In our view, it would be more appropriate, given the types of firm likely to be caught by the core and limited scope regimes, to apply the regulatory reference regime in a lighter touch way to such firms. This would acknowledge the resources required to (a) maintain records to comply with the regime and (b) provide references in accordance with the prescribed form. For example, core and/or limited scope firms might be required to provide regulatory references but use of form could be voluntary.

4) Related to this, the guidance at SYSC 22.6.5 that fairness "*may require a firm to have given an employee an opportunity to comment on an allegation*" may impose a disproportionate burden on smaller firms in circumstances where they identify wrongdoing (or impose a sanction, such as a disclosable remuneration sanction) after the employment has terminated. Giving employees in those circumstances a right to a hearing may not be practical. To address this point under the Extended Regime, the "fairness" requirement could be subject to the "size and resources" of the relevant firm.

Fairness

5) As highlighted in our 2015 Response, under the regulatory reference regime, fairness to employees is potentially sacrificed in order to safeguard consumers. This risk is particularly acute where firms decide to provide information in a regulatory reference in circumstances where an employee has not had the opportunity to comment (as referenced above) or where an employee leaves the firm prior to the conclusion of an investigation or disciplinary process.

6) In light of this, and notwithstanding our comments under paragraph 4) above, we suggest that firms should be obliged to state that the former employee has not had an opportunity to comment and/or that the investigation/ disciplinary process was not concluded before the employee left where remarks are made in this context. This would have the effect of

reinforcing the provision in SSYC 22.5.4 reminding employers of their duty under the general law to exercise due skill and care in relation to employment references.

7) In our view, guidance on fairness will be particularly important under the Extended Regime given the array of firms who will be caught and the varying levels of legal, compliance and HR resources that they will have at their disposal.

Definition of "disciplinary action"

8) In our 2015 Response we identified some concerns in relation to the definition of "disciplinary action" in section 64C FSMA. We note that the reduction or recovery of remuneration should only be notified and included in a regulatory reference's mandatory disclosures where it is imposed due to a breach of an individual conduct requirement (rather than triggered by a downturn in financial performance). In our response to FCA CP15/31 we highlighted that it would be inappropriate for such disclosures to be mandated where they have not resulted from concluded misconduct investigations.

9) There are a number of non-conduct related scenarios (for example performance or capability issues) where conduct breaches could give rise or at least contribute to decisions to reduce compensation. It should be made clear to firms that such scenarios are not required to be included in a mandatory regulatory reference disclosure. As we noted in our 2015 Response, "breaches of some conduct rules may not engage any disciplinary procedure as such - in particular, conduct rule 2 ("You must act with due skill, care and diligence"). Such breaches may have been treated as performance issues at the time, may not have engaged any procedural protection, and may not even have been notified to the individual, at least not as a breach of a conduct rule as distinct from a general concern about performance or lack of experience". This gives rise to potential uncertainty (on the part of both employer and employee) and unfairness where an individual's regulatory reference includes disclosures in respect of matters where their conduct was never in question and where they had no "right of reply" at the time in relation to the firm's assessment of whether a conduct rule had been breached. This risk is significantly increased given the vastly increased number of firms to be caught by the Extended Regime (many of whom will be less equipped than firms caught by the Banking Regime to determine when an issue of conduct or performance gives rise to a conduct rule breach).

10) Under the Banking Regime, firms have had difficulty in assessing whether to disclose disciplinary action that occurred prior to the implementation of the Banking Regime (for RAPs, pre-March 2016) (which they must do if "*the basis on which it took that action amounts to a breach of any individual conduct requirements*" (as per SYSC 22.6.3)). This seems to require the firm to turn its mind to whether the previous disciplinary action would have amounted to a breach of any relevant conduct rules. SYSC TP 5.4.5R disapplies that requirement where records "*do not record whether the previous conduct subject to disciplinary action amounted to a breach*". But in practice it may be apparent that the disciplinary action did amount to a breach of the (APER) conduct rules, or would have amounted to a breach of the new conduct rules had it happened post-March 2016, and in those circumstances firms are unclear whether or not they should make a disclosure. We would ask that the FCA takes the opportunity to clarify the guidance on this point when extending the regime to all authorised firms. Firms would also benefit from confirmation as to

whether the “conduct requirements” specified in SYSC 22.6.3 refer to the conduct rules in place under APER at the relevant time or under the new conduct rules.

The template prescribed under SYSC 22 Annex 1

11) There is also some confusion, in our experience, about the disclosures that should be made by a firm providing a reference in response to template question G ("*Are we aware of any other information that we reasonably consider to be relevant to your assessment of whether the individual is fit and proper*"), and in what circumstances this would require disclosures over and above those matters disclosed in response to template question F. In our experience, this is causing firms to "over-comply" by disclosing any disciplinary matter at all which may (or may not) be relevant, so as to ensure that the firm cannot be criticised for a failure to disclose. This has a negative impact on both the employee who is subject to the reference, and the firm in receipt of the reference (who may be unable to take an informed view of the seriousness of the matters disclosed). Again, some further guidance from the FCA on the materiality of disclosures required by this provision under the Banking Regime and Extended Regime (given the guidance provided in respect of question F) would be welcome.

"Reasonable steps"

12) It is not clear how far an employer should go in order to meet the requirement that it take "reasonable steps" to obtain a reference before appointing an individual to a relevant role (SYSC 22.2.1R). We are concerned that smaller employers will have limited resources to chase down missing references from multiple previous employers. For smaller firms (for example core or limited scope firms), it might be reasonable to require them to make the request (only), and then be free to appoint after the expiry of a defined period (so that it is clear at what point they can proceed with the appointment).

Question 33: Do you agree with our proposal to introduce a new Prescribed

Responsibility for the Conduct Rules that will also apply to banking firms?
Summary

13) In relation to training, we have no objection to the new prescribed responsibility. In relation to reporting, we suggest that the proposal should be reformulated, but otherwise there is no principled reason why the prescribed responsibility should not be introduced.

New prescribed responsibility

14) The new FCA-prescribed senior management responsibility as set out in the table at SYSC 24.2.6R is as follows: "Responsibility for the firm's obligations in relation to conduct rules for: (a) training; and (b) reporting". The explanation accompanying that prescribed responsibility in the table relevantly provides as follows: "(2) The firm's reporting obligations mean its obligations under section 64C of the Act (Requirement for authorised persons to notify regulator of disciplinary action)." This is referred to as the "**Conduct Rules PR**" below.

Reporting requirements

15) Section 64C of FSMA and the rules made thereunder require that if disciplinary action (namely a formal written warning, a suspension, dismissal, or the reduction/recovery of remuneration) is taken against a relevant person where the reason or one of the reasons for

that disciplinary action is a breach of the conduct rules, a notification must be made to the appropriate regulator.

16) The rules implementing the section 64C requirement require the submission of particular forms in certain circumstances, namely Form C, Form D, Form L and Form H. Forms C and D concern senior managers, and Forms L and H concern certified persons and auxiliary staff.

Commentary

17) The application of the Conduct Rules PR is reasonably straightforward in respect of certified persons and auxiliary staff, in that there is no alternative notification required if either disciplinary action is not taken or not taken for the relevant reasons (unless due to, for example, the seriousness of the conduct in question).

18) By contrast, for senior managers, if a person ceases to perform the function in question, Form C must be submitted regardless of the reason for the person ceasing to perform that function. Consequently, the drafting of the Conduct Rules PR has the oddity that if a senior manager leaves a firm by any other means than dismissal (including a resignation whilst under investigation), the senior manager holding the Conduct Rules PR will not be responsible for any notifications that result from that departure.

19) Similarly, the Conduct Rules PR bites upon a Form D notification which entails a conduct rules breach with associated disciplinary action, but not any other kind of change in a person's fitness and propriety. If, for example, a senior manager were charged with a serious criminal offence in relation to matters outside of work (e.g. fraud), Form D must be submitted, but the Conduct Rules PR would not be applicable to that notification.

20) It is not clear why the regulators should be particularly concerned to ensure that there is a specific senior management responsibility for the notification to the regulator of disciplinary action caught by section 64C FSMA, but not specific senior management responsibility for the notification to the regulator of other serious matters going to the fitness and propriety of a senior manager.

21) It is, further, our experience that some of the most difficult and contentious decisions within firms concerning notifications are about what should be said to the regulator on Form C or Form D where no disciplinary action has resulted from the conduct in question, but where there are concerns about individuals which might be of interest to the regulators. The benefits identified by the regulator in relation to section 64C FSMA notifications would, in our view, be equally applicable to these difficult situations also.

Concerns

22) We therefore have the following concerns about the Conduct Rules PR.

23) First, the drafting of the Conduct Rules PR does not reflect the practical reality of how notifications to the regulators are made in respect of individuals. Normally, one part of the

firm will be responsible for the submission of Forms C and D, and it is not clear why a senior manager should have responsibility for that process in some circumstances but not others.

24) Second, potentially, the drafting of this prescribed responsibility provides perverse incentives for firms not to impose disciplinary sanctions, and not to find that they have been imposed for reasons relating to breaches of the conduct rules, because the senior manager with the Conduct Rules PR will not thereby bear responsibility for the resulting notification if that incentive is responded to.

25) We therefore suggest that it would be far more straightforward if either:
    a) the Conduct Rules PR were re-drafted to concern responsibility for the content and submission of Forms C, D, L and H. This widening of the Conduct Rules PR would ensure that decisions concerning notifications relating to individuals were always made with a senior manager having responsibility for the decision-making process in question (rather than only if a certain outcome were reached), and it would remove any incentive for gaming the notifications process; or
    b) the Conduct Rules PR were re-drafted to concern only responsibility for training and for processes and procedures for identifying and reporting conduct rules breaches, rather than requiring the senior manager having responsibility for this area to be involved in every breach and notification.

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APPENDIX

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