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ASHURST LLP

SM&CR extension: automatic conversion and transitional provisions announced

FINANCIAL REGULATION BRIEFING

December 2017

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Introduction

On 13th December 2017, the FCA published details of the proposed transitional arrangements for FCA solo-regulated firms which will govern the change from the current Approved Persons Regime to the Senior Managers and Certification Regime ("SM&CR"). Disappointingly, no confirmation has been given on the date of commencement of the new regime (this is a matter for HM Treasury, rather than the FCA) although the FCA has said it is planning for a mid-to-late 2019 commencement. However, the good news is that for the majority of FCA solo-regulated firms (notably Core and Limited Scope Firms) the FCA has proposed that there will be automatic conversion of senior individuals from the current Approved Persons Regime to the SM&CR. This is much less onerous than many had feared. Indeed it is only Enhanced firms who will be required to submit a conversion notification and accompanying documents (which include Statements of Responsibility).

Some may say that the FCA has delivered an early Christmas present to many.



Background

A deluge of papers has been published on various aspects of the SM&CR recently. Three papers were released by the FCA:

1. CP17/40: Individual accountability: Transitioning FCA firms and individuals to the Senior Managers & Certification Regime ("CP17/40");
2. CP17/41: Individual accountability: Transitioning insurers and individuals to the Senior Managers & Certification Regime (which considers the arrangements for insurers to transfer to the SM&CR from the existing Senior Insurance Managers Regime ("SIMR") and which we do not propose covering in this briefing); and
3. CP17/42: The Duty of Responsibility for insurers and FCA solo-regulated firms ("CP17/42").

And a corresponding paper from the PRA has also been published dealing with the conversion from SIMR to SM&CR for insurers.

This note summarises the FCA proposals for the transitional arrangements for FCA solo-regulated firms following the FCA's proposals in summer this year which set out how it intends the existing rules for banks and PRA investment firms under SM&CR to apply to all FCA authorised firms. As a reminder, the FCA proposed splitting FCA authorised firms in to three categories:

ENHANCED FIRMS	CORE FIRMS	LIMITED SCOPE FIRMS
<ul style="list-style-type: none"> • Significant investment (IFPRU) firms • Firms that are CASS Large firms • Firms with assets under management of £50billion or more • Firms with total intermediary regulated business revenue of £35 million or more per annum • Firms with annual regulated revenue generated by consumer credit lending of £100 million or more per annum • Mortgage lenders that are not banks with 10,000 or more regulated mortgages outstanding 	<p>All other FCA solo-regulated firms not caught as an Enhanced firm or Limited Scope firm.</p>	<ul style="list-style-type: none"> • Limited permission consumer credit firms • Sole traders • Authorised professional firms whose only regulated activities are in non-mainstream regulated activities • Oil market participants • Service companies • Energy market participants • Subsidiaries of local authorities or registered social landlords • Insurance intermediaries whose principal business is not insurance intermediation and who only have permission to carry on insurance mediation activity in relation to non-investment insurance contracts • Internally managed AIFs

The transitional arrangements set out in CP17/40 depend on a firm's classification; Enhanced firms are subject to more onerous requirements than Core or Limited Scope firms.

Key points

- The FCA will automatically convert relevant controlled function holders to corresponding Senior Management Functions in almost all cases for Core and Limited Scope firms;
- Core and Limited Scope firms do not need to submit forms to the regulator in advance of the commencement date;
- Core and Limited Scope firms should ensure that the correct individuals are performing the right controlled functions under the existing Approved Persons Regime, in advance of the commencement date to ensure that automatic conversion results in the right senior managers for the firm;
- Enhanced firms must submit forms setting out their senior managers and accompanying documents, such as the senior managers' Statements of Responsibilities and the firm's Responsibilities Map, to the regulator in advance of the commencement date;
- Failure by an Enhanced firm to submit the correct forms at the required time will be a regulatory breach (which is likely to fall to the senior manager with the prescribed responsibility for implementation of the Senior Managers Regime).

Core or Limited Scope firm conversion

The FCA has announced its intention to automatically convert approved individuals at Core and Limited Scope firms to new Senior Management Functions. The following table sets out the corresponding Senior Management Function for each current controlled function:

CURRENT CONTROLLED FUNCTION	POSSIBLE CORRESPONDING SENIOR MANAGEMENT FUNCTIONS
CF1 - Director	SMF3 - Executive Director
CF2 - Non-Executive Director	SMF9 - Chair
CF3 - Chief Executive	SMF1 - Chief Executive
	SMF19 - Head of Third Country Branch
CF4 - Partner	SMF - Executive Director (only for EEA and non-EEA branches)
	SMF27 - Partner
CF5 - Director of Unincorporated Association	SMF3 - Executive Director
CF6 - Small Friendly Society Function	SMF3 - Executive Director
CF8 - Apportionment and Oversight Function	SMF29 - Limited Scope
CF10 - Compliance Oversight	SMF16 - Compliance Oversight
CF11 - Money Laundering Reporting Officer (MLRO)	SMF17 - Money Laundering Reporting Officer (MLRO)
CF29 - Significant Management Function	SMF21 - EEA Branch Senior Management Function

Every converted senior manager at a Core or Limited Scope firm must have a Statement of Responsibilities (SoR), even though such documents are not required to be submitted to the FCA at conversion. The FCA also has the right to request a senior manager's SoR at any time so Core and Limited Scope firms must therefore be prepared to provide them on request, once the new regime is in force.

There is one exception to the automatic conversion which is where firms have a CF2 – Non-Executive Director performing the role of Chair. The FCA currently approves a firm's non-executive Chair under the generic CF2 – NED function. This means that the FCA will not know whether an individual CF2 performs the Chair role, unless firms tell them. The FCA therefore will require firms with a non-executive Chair to submit a Form K, telling the regulator that they wish to convert an approved NED to the SMF9 – Chair function. If a Form K is not submitted for the Chair, the individual's approval will lapse at the start of the new regime. All other NEDs (known as 'ordinary NEDs' under the SM&CR rules) at Core and Limited Scope firms will no longer be approved by the FCA although they will still be subject to certain extra requirements on top of the Conduct Rules.

A number of existing approved roles in Core and Limited Scope firms will fall away at SM&CR commencement. Such roles will not be automatically converted because these roles will no longer require approval by the FCA. However, some of these roles will fall into the Certification Regime.

THESE FUNCTIONS ARE:

- CF2 – Non-Executive Director (NED) (with the exception of an SMF9 – Chair (noted above));
- CF10a – CASS Oversight Function;
- CF28 – Systems & Controls Function;
- CF29 – Significant Management Function (though this can be converted to the new EEA Branch Manager Function for EEA Branches); and
- CF30 – Customer Function.

Individuals performing these functions will generally not be converted to a new Senior Management Function except where the firm actively requests their transfer to a Senior Management Function. If they fall within the certification regime (such as the CASS oversight function), they will be subject to the firm's obligation to assess their fitness and propriety, rather than the regulator.

The existing processes for individual applications under the Approved Persons Regime will continue to apply as usual, until the commencement of SM&CR. Firms will need to comply with the Approved Persons Regime until that date. In the case of 'in-flight applications', where a firm has submitted an application under the Approved Persons Regime prior to the start of the new SM&CR rules, but such application has not been determined before the commencement date of SM&CR rules, the regulator will ensure that the Approved Persons Regime application will be automatically converted to an application for the relevant Senior Management Function on commencement.

Enhanced conversion

In contrast, Enhanced FCA solo-regulated firms will have to tell the regulator who they want to assign to the new Senior Management Functions. Such firms will not have to re-apply for an individual's approval if the proposed Senior Management Functions can be mapped directly from the Approved Persons Regime. Nor is there a requirement for these firms to do extra checks on these individuals when they are converted. This means that prior to commencement, Enhanced firms will need to submit:

- a Form K conversion notification detailing all of the approved persons to be converted to Senior Management Functions at commencement;
- a SoR for each individual; and
- a Responsibilities Map to convert existing approved individuals to new Senior Management Functions.

For Enhanced firms, the conversion table (which we have set out at the appendix to this briefing) is more complex than for Core and Limited Scope firms because there are more possibilities of which Senior Management Functions the current controlled functions holders may transfer to. For this reason it makes sense that an Enhanced firm must take an active step to assess and confirm to the regulator who will perform which Senior Management Function.

The FCA has made it very clear that if an Enhanced firm doesn't submit a conversion notification (i.e. the Form K), it will be in breach of regulatory requirements. Consequently, Approved Persons Regime approvals will lapse and the firm will not have any senior manager approvals. This means that they will have no-one approved by the regulator and will be in breach of the rules. The FCA notes that in this scenario it will consider what further regulatory action needs to be taken if the firm is unable to rectify the breach, including possible enforcement action.

Fitness and propriety

There are some minor proposed changes to the questions that are asked on FCA forms in relation to the fitness and propriety of an individual. In this respect, the FCA has added text to include: (i) whether the candidate has ever been found by a judge or tribunal to have lied under oath and/or that their evidence was to be disbelieved; (ii) a 10 year time limit to the period in which an individual has to declare if a firm in which the individual has held a position of influence has been adjudged by a court to be civilly liable for any fraud, malfeasance, wrongful trading or other misconduct, the subject of a judgement debt or award against the firm or party to any other civil proceedings which resulted in an order against the firm other than above; and (iii) whether the candidate has ever participated in arbitration proceedings.

Firms may wish to consider what impact these amendments should have on their own internal assessment of candidates fitness and propriety and data gathering process.

Financial Services Register

It has been highlighted to the regulator that as a result of the proposals for firms subject to SM&CR, only details of people holding Senior Management Functions will be included on the Financial Services Register following commencement. This is because Senior Management Functions will be the only roles approved by the FCA under the new regime. This means that people performing certified functions will not appear on the Financial Services Register following the extension of the SM&CR who otherwise would have under the Approved Persons Regime (such as CASS oversight function or CF30 customer facing rules).

Some commentators have noted that this will dramatically reduce the information that is publicly available on those working within financial services, and in particular those who may work in customer facing roles. Some consider the Financial Services Register to be a useful way to check the validity of the person with whom they are interacting or transacting, for example.

The FCA acknowledges these concerns and is considering what, if any, next steps there should be in relation to the Financial Services Register as part of the preparations to implement the new regime.

Consequential amendments

Finally, there are a couple of small changes to note:

- Gender neutral titles

Along with the PRA, the regulators plan to introduce gender-neutral language to the titles of the SM&CR functions. This will affect roles that include the word 'Chairman', which the regulators propose to amend to 'Chair'.

- SMF24 – chief operations function

There has been some confusion following the FCA's proposals on what amounts to a SMF24 role. The FCA has therefore proposed further guidance to clarify its expectations of the areas of responsibility relevant to the SMF24 role. As a result the role is more aligned with the current SMF24 for banks and insurers, and includes responsibility for areas such as:

- Business continuity;
- Cybersecurity;
- Information technology;
- Internal operations;
- Operational continuity, resilience and strategy;
- Outsourcing, procurement and vendor management; and
- Shared services.

Duty of responsibility

Finally, a paper has also been published to consider the impact of the extension of the SM&CR on the duty of responsibility (CP17/42). The duty of responsibility was introduced in the SM&CR for banks and PRA investment firms via the Financial Services Act 2016. It specifies that the FCA may take action against a senior manager where:

- (i) there was a contravention of a relevant requirement by the senior manager's firm;
- (ii) at the time of the contravention or during any part of it, the senior manager was responsible for the management of any of the firm's activities in relation to which the contravention occurred; and
- (iii) the senior manager did not take such steps as a person in their position could reasonably have been expected to take to avoid the contravention occurring or continuing.

The burden of proof lies with the FCA to show that the individual did not satisfy limb (iii). The duty of responsibility currently applies to senior managers of banking firms, but will be extended to FCA solo-regulated firms from the commencement date.

The FCA has therefore published CP17/42 setting out its approach to the application of its current guidance on the enforcement of the duty of responsibility, as set out in the Decision Procedure and Penalties Manual in the FCA Handbook (DEPP 6.2.9).

The key elements of the FCA's approach to enforcement under the extended regime are:

- (i) **Threshold for enforcement action:** The FCA will consider the same factors as are currently set out in DEPP when assessing the duty. These include, but are not limited to: the seriousness of the breach in question, the position and seniority of the senior manager and issues of proportionality. The FCA does not believe that there is a need for any additional threshold when assessing the conduct of senior managers of FCA solo-regulated firms.
- (ii) **Application of retrospective standards:** The FCA has maintained that it will not apply the relevant standards retrospectively (DEPP 6.2.9-D G).
- (iii) **Statement of Responsibilities:** Firms must prepare a statement of responsibilities when applying for a senior manager to be approved under the SM&CR. But, the FCA has confirmed scope of the duty of responsibility will not be confined to the responsibilities set out in the statement of responsibilities. Whether an individual was responsible for the management of any of a firm's activities will continue to primarily be a question of fact, with statements of responsibility only providing additional guidance.

As expected, this consultation gives clarity that there will not be a proportionate approach taken in relation to the enforcement aspect of the SM&CR for FCA solo regulated firms.

Conclusion

These papers were not unexpected: the FCA promised in its summer consultation to publish its approach to the transitional arrangements by the end of this year. What is surprising, however, is that the FCA has lifted the administrative burden so substantially for Core and Limited Scope firms, and more importantly for itself. Now the question on everyone's lips is when the extended regime will start. And for that we need a statement from the Treasury.



Appendix

Proposed function mapping for Enhanced Firms

CURRENT CONTROLLED FUNCTION	POSSIBLE CORRESPONDING SENIOR MANAGEMENT FUNCTION(S)
CF1 - Director	SMF2 - Chief Finance Officer
	SMF3 - Executive Director
	SMF4 - Chief Risk Officer
	SMF5 - Head of Internal Audit
	SMF7 - Group Entity Senior Manager
	SMF24 - Chief Operations
CF2 - Non-Executive Director	SMF9 - Chair
	SMF10 - Chair of the Risk Committee
	SMF11 - Chair of the Audit Committee
	SMF12 - Chair of the Remuneration Committee
	SMF13 - Chair of the Nomination Committee
	SMF14 - Senior Independent Director
	SMF7 - Group Entity Senior Manager
CF3 - Chief Executive	SMF1 - Chief Executive
	SMF2 - Chief Finance Officer
	SMF4 - Chief Risk Officer
	SMF5 - Head of Internal Audit
CF5 - Director of Unincorporated Association	SMF3 - Executive Director
	SMF2 - Chief Finance Officer
	SMF4 - Chief Risk Officer
	SMF5 - Head of Internal Audit
	SMF7 - Group Entity Senior Manager
CF6 - Small Friendly Society Function	SMF3 - Executive Director
	SMF2 - Chief Finance Officer
	SMF4 - Chief Risk Officer
	SMF5 - Head of Internal Audit
	SMF7 - Group Entity Senior Manager
CF10 - Compliance Oversight	SMF16 - Compliance Oversight
	SMF24 - Chief Operations

CF10a - CASS Operational Oversight Function	<p>SMF18 - Other Overall Responsibility</p> <p>If an Enhanced firm elects not to convert an individual performing a CF10a (CASS Oversight) function to SMF18 (Other Overall Responsibility) function, then this individual should be certified under the Certification Regime. The CASS prescribed responsibility should then be allocated to the Senior Manager to whom the individual reports.</p>
CF11 - Money Laundering Reporting Officer (MLRO)	SMF17 - Money Laundering Reporting Officer (MLRO)
CF28 - Systems and Controls Function	Function
	SMF4 - Chief Risk Officer
	SMF5 - Head of Internal Audit
CF29 - Significant Management Function	SMF18 - Other Overall Responsibility
	SMF24 - Chief Operations

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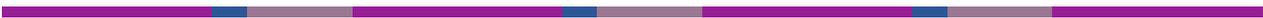
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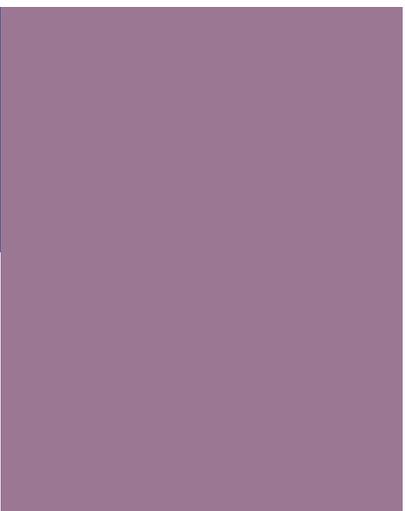
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