CAPITAL MARKETS
SMCR

Back in the boardroom

The new regime will be extended to insurers and beyond, as part of a broader conversation about cultural change

The senior managers and certification regime (SMCR) is back on the agenda. Following months of consultation, on July 4 2018 the Financial Conduct Authority (FCA) published its near-final rules on the rollout of SMCR to insurers and other regulated financial services firms. Originally introduced in the UK banking sector in 2016, this package of regulatory rules and standards will apply to nearly all insurers from December 10 2018 and all other Financial Services and Markets Act (FSMA)-authorised firms regulated by the FCA from December 2019.

The rollout of SMCR will change the way many businesses in the financial services sector operate, requiring a number of significant (and often burdensome) changes to compliance and human resource functions. But it is also about more than just compliance with the strict letter of the regulations – it is about instilling a new culture in financial services from the top down.

SMCR in a nutshell

Despite its name, SMCR is not a single or even dual regime. It's a triumvirate of regimes: (i) the senior manager regime; (ii) the certification regime; and (iii) the conduct rules. First introduced in the banking sector in 2016 by both the FCA and the Prudential Regulation Authority (PRA), the SMCR is a framework of rules that aims to ensure that key responsibilities within a firm are clearly assigned to individuals, who are personally accountable, and that staff occupying certain positions (such as senior managers and material risk takers) are fit and proper to do so and comply with mandatory standards of behaviour.

It is designed to change the culture of firms and improve standards, in an effort to ward off further financial crises and the significant conduct failings of the past, such as the manipulation of Libor, Euribor and the FX markets.

1 MINUTE READ

The senior managers and certification regime (SMCR) was originally introduced in the UK banking sector in 2016, and will apply to nearly all insurers from December 10 2018. It will apply to all Financial Services and Markets Act authorised firms regulated by the Financial Conduct Authority from December 2019.

The extension of SMCR will present challenges for firms new to the regime, but it also represents a prime opportunity for firms to engage in a broader exercise of cultural self-reflection, changing management and employee attitudes and mind-sets, to the benefit of not just the firm, but customers, clients and consumers.

Who is next in the sights?

On December 10 2018, the SMCR will be extended to almost all insurance firms, building on and replacing the existing senior insurance managers regime (SIMR) and approved persons regime. While many of the concepts of SMCR will be familiar ground for insurers, the certification regime will be a fundamental change in approach requiring significant forward planning and administration.

A full-scope SMCR regime will apply to all Solvency II firms and large non-directive firms (NDFs), and a streamlined regime will apply to small NDFs, small run-off vehicles and insurance special purpose vehicles (ISPVs). All insurers, however, regulated by the FCA and PRA will be affected.

The principal changes under the new regime for insurers are:

- *Regulatory approval* As with the SIMR, senior managers performing key roles (senior management functions) will need regulatory approval before commencing their roles. Key function holders, however, and other categories of roles such as material risk takers will no longer require regulatory approval. Instead, individuals occupying these roles will need to be certified by the firm itself under the certification regime (see below).
- *Functions* The SMCR will introduce a number of new senior management functions (SMFs), including executive director (SMF3), compliance oversight (SMF16), money laundering reporting officer (SMF17), conduct risk oversight (SMF23b) and other overall responsibility (SMF18). The relevance and applicability of these functions will vary between firms.
- *New duty of responsibility* In keeping with the aim of the SMCR to increase individual accountability, a new duty of responsibility is introduced for those identified as senior managers. In the event a regulator determines that a senior manager did not take reasonable steps to prevent wrongdoing in an area for which they are responsible, the senior manager may be held personally accountable by the regulator and subject to direct enforcement action.
- *New handover rules* Given the focus on personal accountability (and the consequence of getting it wrong), particularly for senior managers, it is important that new incumbents to senior manager roles are properly prepared for their duties. For large insurers, the SMCR will introduce new handover rules, requiring firms to take reasonable steps to ensure that a person taking on a senior manager role has all the relevant material they could reasonably expect to have to do the job effectively.
- *New certification regime* The certification regime will effectively replace the current approved persons regime, extend to a greater number of employees, and will shift the regulatory burden of certification directly on to insurers. The regime will apply to all individuals other than senior managers (who must be pre-approved by the regulator) performing certification functions (CFs) – in essence, any employee whose role may have an impact on customers, markets and the insurer, including those currently designated as key function holders under the SIMR and material risk takers.
- Insurers will need to assess and self-certify (on at least an annual basis) that each employee carrying out a CF is fit and proper to do so. Fitness and propriety are to be assessed by reference to PRA and FCA guidance, and include consideration of an individual's honesty, integrity and reputation; competency and capability; and financial soundness. This assessment can include a broad array of considerations, including behaviour unrelated to the certified employee's particular role. Megan Butler, the FCA's director of supervision – investment, wholesale and specialist, for example, informed the House of Commons Women and Equalities Committee in May that complaints of sexual harassment could be taken into account when assessing fitness and propriety. She commented that assessments should 'encompass the whole of [an] individual' and not just their financial decision-making. "Misconduct is misconduct, whether it is financial or non-financial,' she said.
- *New conduct rules* Approved persons in insurers are already subject to conduct rules under the SIMR and the APR. The SMCR's conduct rules will, however, apply to a much broader range of employees, covering all employees working in financial services (other than ancillary staff), and covering any activities (whether a regulated activity or not) that could affect the integrity of the UK financial system or impair or affect the firm's ability to meet certain regulatory requirements. Each in-scope employee who fails to comply with the conduct rules could find themselves subject to direct enforcement by the FCA or PRA. Insurers will need to ensure that each of their employees is aware of whether they are subject to the conduct rules and, for those in scope, provide training so that each employee has a broad understanding of the rules and how they apply in practice to their specific role.
- *Rebranding of regulatory documents* Scope of responsibilities documents and governance maps will be replaced by statements of responsibilities and management responsibilities maps. This is largely a rebranding exercise, the essential purpose of each document remaining the same. Insurers will need to submit a statement of responsibilities with each approval application for a new senior manager. Large insurers will also need to prepare and submit a management responsibilities map – a single document setting out the firm's management and governance processes, including the allocation of regulator-prescribed responsibilities. Firms will be required to update their statements of responsibilities and management responsibilities maps on an ongoing basis; significant updates will require re-submission to the regulator.

Each in-scope employee who fails to comply with the conduct rules could find themselves subject to enforcement by the FCA or PRA

What steps should insurers be taking now?

Preparations will hopefully be well underway in many insurers for the introduction of the SMCR in December later this year. Key action points, however, should include at least the following:

- Conducting a review of existing SIMR senior manager roles and responsibilities and comparing these with the new requirements under the SMCR – in particular, identifying any gaps.
- Similarly, reviewing existing scope of responsibilities documents and governance maps to identify gaps and ensuring they comply with requirements as to form under the SMCR.
- Preparing revised service contracts for senior managers and revised handbooks and policies (including a new handover policy).
- Identifying all employees who will need to be certified under the certification regime. This will include key function holders, material risk takers, and those carrying out certain other FCA-designated functions.
- Designing a communications plan, and preparing draft communications, notifying the proposed certified employee population of their inclusion within the certification regime and the implications for their roles.
- Reviewing existing codes of conduct, ethical principles and staff handbooks to ensure their key principles are consistent with the new conduct rules.
- Designing or procuring training for employees who will be subject to the conduct rules pre-implementation to ensure they are aware of their responsibilities and the potential consequences of breaching the conduct rules.
- Establishing systems for conducting fitness and propriety assessments, for recording conduct rule breaches, and for reporting breaches to the regulators.

The FCA's near final rules show that different levels of SMCR regulation will apply to firms depending on their size and function

Roll-out of the SMCR to remaining FSMA-authorised firms regulated by FCA

On July 3 2018, the Economic Secretary to the Treasury, John Glen, confirmed in a statement to the House of Commons that the SMCR would be rolled out to all remaining firms regulated by the FCA from December 9 2019. It is anticipated that, when fully implemented, SMCR will apply to approximately 47,000 firms, in addition to those already subject to the regime in the banking sector.

While the SMCR is an extensive and thorough collection of regulations, the near final rules published by the FCA show that, as with its extension to insurers, different levels of SMCR regulation will apply to firms depending on their size and function. This is clearly a sensible and reassuring approach so that medium and small-sized firms, and solo traders, are not disproportionately overwhelmed.

With just over one year to go until the final SMCR rollout, all remaining regulated firms who will be captured should be starting to familiarise themselves with the requirements of the regime and to plan for its implementation.

Changing the culture

Dealing with the black letter requirements of the SMCR is only part of the picture.

The extension of the SMCR to the regulated financial services sector as a whole is intended to change the culture of firms – one where personal accountability is the norm, accepted rather than avoided. And the FCA is expecting to see this shift in firms' cultures.

On March 12 2018, the FCA published a discussion paper on transforming culture in financial services. In a covering note, it set out its clear view on the importance of culture generally and the relevance of SMCR to effecting change:

> *'Culture and governance is a priority for the FCA and we have a strong focus on the role of the individual as well as the firm. The FCA has considered the role of leaders, incentives and capabilities, and governance of decision making. The introduction of the Senior Managers and Certification Regime (SM&CR) is an example of this; it sets minimum standards for the behaviour of financial services staff and aims to promote a culture where Senior Managers take responsibility for identifying where harm might occur, and take action to prevent it. The SM&CR creates a formal link between the behaviour of individuals and the conduct of the firm.'*

By formalising personal accountability (whether for particular responsibilities, roles, or personal conduct) it is expected that individuals will improve their conduct, rigour and standards of decision-making, benefiting not only the firm but clients, customers and consumers. It is also a top-down affair, requiring leadership and compliance from the very top in senior managers through to more junior ranks in the certified employee population. The FCA expects leadership to set the tone, and individual accountability at all levels.

The focus on changing culture makes the implementation of the SMCR a prime opportunity for regulated firms going through the process to engage in a broader exercise of self-reflection, questioning whether they have a good, healthy culture. Do individuals feel free to speak up if they have concerns? Do managers lead by example? Is there a diversity of talent encouraging thoughtful risk management and a balance of opinions? Is there a gender pay gap?

While the regulations of the SMCR may be burdensome, they are introduced with good intentions. Those firms who embrace it, and the broader conversation about cultural change, may find that in otherwise saturated markets, it is their positive and progressive culture that distinguishes them most.

Louise Skinner
Partner
Morgan Lewis & Bockius
(London)

Thomas Twitchett
Associate
Morgan Lewis & Bockius
(London)