Many Happy Returns, SMCR

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- **First 12 months; first real test for SMCR**
- **The bigger picture – SMCR, culture, conduct, governance and social trends**
- **Why the Conduct Rules matter**

This December sees the first anniversary of the commencement of the Senior Managers and Certification Regime ("SMCR") for 'solo-regulated firms'.[1]

SMCR was a long time in the making. Following the 2008 financial crisis, a UK Parliamentary Commission looked into banking standards, including making individual responsibility a reality. Thereafter, the UK regulators (the Financial Conduct Authority **("FCA")** and the Prudential Regulation Authority **("PRA")**) **introduced SMCR in March 2016**. Initially the regime was rolled out for credit institutions and major investment firms. Insurance companies followed in 2018 with the requirements taking effect for the remainder of FCA regulated firms on **9th December 2019**.

SMCR is an integral component in a major regulatory initiative to improve conduct and culture at financial institutions. The FCA and the PRA consider SMCR to be a 'game changer' within the industry. Among other considerations, an improved framework governing the behaviour of individuals is expected to mean that the financial services industry is better placed to respond to future crises; both systemic and within individual firms.

When a new regulatory regime takes effect, typically the first 12 months represents a 'bedding down' period. Firms, regulators and other stakeholders adopt the requirements and new industry standards develop. Regarding SMCR, requirements have included procedural aspects such as: establishing protocols for the take-on and training of employees; assigning responsibilities to senior managers; obtaining references from former employers; conducting criminal checks; and ensuring that disciplinary procedures are fit-for-purpose.

More pertinently, senior individuals within financial institutions have been encouraged to change their mind-set. There has been a transition from an emphasis on collective responsibility to recognising the importance of **individual responsibility**. The concept of the 'tone from above' has a sharper focus. Fostering the right culture within an organisation is becoming more

1 Firms that are authorised and regulated by the UK Financial Conduct Authority. Almost all UK investment firms and asset managers fall into this category.

of a competitive advantage. It is perhaps these aspects of the framework rather than the minutiae of the rules that makes SMCR so impactful.

Barely 3 months into the new regime, disruption caused by the onset of COVID-19 started to take effect. For many firms and senior managers, this was the first real test under the new SMCR framework.

At this time, senior managers were in the nascent stages of establishing personal responsibility over particular business areas. As permitted by the regime, senior managers could delegate tasks to more junior staff members but – crucially – they retained the personal responsibility to appropriately supervise the staff working under them.

The swift transition to extensive working from home presented the unprecedented challenge of not having physical proximity to delegates on an ongoing, every day basis which made it more difficult to supervise others and to effectively delegate tasks. Moreover, this came at a time where senior managers were also busy enacting contingency arrangements and making strategic and commercial assessments.

In this way, COVID-19 could be considered to be part of a wider heading - transition management. And whilst this year has been somewhat overshadowed by the virus, 2020 has many other moving parts. Brexit is one such example. The juxtaposition of COVID-19 and Brexit might create a 'perfect storm' for some firms. Under SMCR, a firm may elect to ascribe a responsibility related to transition, or business change to a senior manager. Given current circumstances, this would arguably be as important a responsibility as one that relates to a particular business unit – IT, human resources, administration, and so on.

In tandem with these developments there is an initiative which is gaining increased traction within the financial services industry – **ESG**. This refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business, namely Environmental, Social, and Corporate Governance. Regulatory initiatives are underway with respect to ESG investing conducted by investment firms, including transparency requirements and the classification of environmentally sustainable activities. Receiving less attention, but also important, are the measures that investment firms are taking *internally* when reviewing operations and factoring ESG considerations. There is an imperative for an investment firm to align this with its SCMR framework.

Consider, for example, the 'S' within 'ESG'. Movements such as '#MeToo' and '#Black-Lives-Matter' have prompted an enhanced focus on diversity and equality. It has raised questions about how fair treatment is supported within a firm culture and upheld in individual conduct. As such, it prompts the need for recognition under SMCR.

Then there is the 'G'. Governance arrangements perform an integral role in the regulatory initiative to improve conduct within financial institutions. Whilst SMCR does not focus on specific governance arrangements per se, the two concepts are inextricably inter-linked. How the senior managers exercise stewardship over the firm, the composition of boards and sub-committees, the management information received by such forums, and the deployment of non-executive directors align with key characteristics of the senior managers regime, such as: individual responsibility; personal accountability; being fit and proper; and leading by example.

Reflecting upon COVID-19, Brexit, ESG and other factors, SMCR's 12 month 'bedding down' period has certainly been eventful

How should firms further develop their SMCR frameworks? Perhaps due to the piecemeal introduction of SMCR-related requirements, the focus to date has been on the more senior individuals within an organisation. However over the coming years, the conduct rules will become more prevalent. In a speech from 2017, Jonathan Davidson, a Director of Supervision at the FCA, expressed a desire for a financial institution's customers to be aware of the conduct rules and to know when these have been breached, similar to suspecting that the Trade Descriptions Act has been breached.

From 31 March 2021, the conduct rules will apply to everyone working in the financial services industry aside from 'ancillary staff' (such as catering staff and security guards). This is the first time that a wide-scale code of conduct has applied

consistently across the financial services industry. This is surprising when one considers that other professions – medical practitioners, social workers, solicitors and many more - have had a code of conduct for some time. The FCA has advised that it expects conduct rules training to be sufficiently robust. For many staff there are only five conduct rules (for example: 'You must act with integrity'); pasting these into an email with a message that 'these now apply' is unlikely to pass muster with the FCA. Instead, it is important for a staff member to understand the context of the conduct rules and how they relate to that staff member given his or her role and responsibilities.

Many firms will face challenges when determining whether or not the conduct rules have been breached. There is a regulatory requirement to report breaches to the FCA, and in some circumstances the breaches – plus potentially issues related to an individual's fitness and propriety - must also be reported to a prospective new employers (for a 6 year period under the 'regulatory references' requirement). If a firm's disciplinary processes are inadequate, or have not been properly thought through, then litigation risk might increase. For example, if an individual has not had the opportunity to refute a firm's assertion that he or she has breached the conduct rules then they may take action against that firm.

2021 could be another eventful year. The COVID-19 crisis may abate and many of the Brexit related issues might be resolved. However there remains the possibility of a sustained economic downturn. The last time this happened, after the credit crunch, the conditions uncovered a spate of poor behaviour that – eventually - led to the introduction of SMCR. There could be a repeat scenario but with a sturdier framework in place. This might coincide with the FCA turning its supervisory attention towards SMCR – the 12 month 'grace period' having expired and having an imperative to take its own disciplinary action against individuals, as a signal that SMCR is effective. The FCA might set an example at all levels, and so the sanctions could include some 'big scalps', and also more junior staff and staff at smaller organisations.

SMCR is neither a stand-alone concept nor a box ticking regulatory exercise. Firms that are ahead of the curve will continue to refine their internal SMCR systems and controls, including ensuring **that good practices** emanate from the top and permeate within an organisation. The FCA has stated that it wants firms to develop a **'culture of accountability'** at all levels. Firms that are more adept in educating their employees on the appropriate behavioural standards and articulating this as a key 'tone from above' message may well find that this will be to their advantage, from both a regulatory and a commercial perspective.