



ADDLESHAW GODDARD

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Approved Persons – Do you understand your obligations?



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Introduction

One of the FSA's recurrent key themes is senior management responsibility. It continues to stress, through speeches and other statements, that it is the responsibility of senior management to ensure that the firm is compliant with its regulatory obligations. The FSA have made it clear that they will use enforcement, against firms or individuals as a strategic tool at the forefront of their drive to achieve "credible deterrence".

The FSA's Enforcement Guide states that it expects *"senior management to take responsibility for ensuring firms identify risks, develop appropriate systems and controls to manage those risks, and ensure that the systems and controls are effective in practice. The FSA will not pursue senior managers where there is no personal culpability. However, where senior managers are themselves responsible for misconduct, the FSA will, where appropriate, bring cases against individuals as well as firms. The FSA believes that deterrence will most effectively be achieved by bringing home to such individuals the consequences of their actions."*¹

Those individuals who carry on 'controlled functions' within firms, and are approved by the FSA, are subject to the fit and proper test for approved persons and the Statements of Principle and Code of Practice for Approved Persons (**APER Handbook**). It is important that approved persons understand their obligations and the action which may be taken against them when things go wrong. It may affect their livelihood.

The Approved Persons Regime

Approved persons fall into two categories:

- ⊕ Those individuals who perform significant influence functions. These are individuals who are involved in the governance of the firm (e.g. directors), carry on certain required functions (e.g. MLRO), systems and controls functions (e.g. setting and controlling risk exposure) and significant management functions (e.g. heading a trading function);
- ⊕ Those individuals who carry on certain activities for customers of the firm. For example, giving advice on, dealing in and arranging deals in investments (the customer function has no application to banking or general insurance).

The functions are subdivided into various categories depending on the role of the individual. Once an individual becomes an approved person they will be responsible for complying with the APER Handbook. The detailed approval requirements to become an approved person are outside the scope of this briefing note but can be found in Chapter 10 of the FSA's Supervision Handbook.

We have referred above to the FSA's focus on senior management. The importance the FSA places on approved persons is demonstrated by the following:

- ⊕ The FSA has confirmed that it will be seeking to hold individuals exercising significant influence over authorised firms accountable for poor conduct at those firms with regard to regulated activities. Whilst historically, the FSA has tended to focus on cases of dishonesty or lack of integrity, in the future, it has made it clear it will consider the competence of individuals holding significant influence functions;²
- ⊕ Since October 2008, the FSA has piloted interviewing more individuals applying for significant influence functions at the largest firms. It believes (and has some evidence from the pilots) that those individuals who have FSA interviews will take up their new roles with more awareness of their regulatory responsibilities. This suggests that FSA interviews are likely to become more common in the future;

¹ The Enforcement Guide (EG 2.31)

² 'How Enforcement Makes a Difference' speech by Margaret Cole, Director of Enforcement, FSA at the Enforcement Law Conference, 18 June 2008



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- ⌚ The FSA approved persons application form has recently been amended to require firms to provide supplementary information about the competence and capability of the candidate.

These changes reiterate the importance of approved persons having the relevant skill set to undertake their role effectively and having a clear understanding of their obligations.

Consultation Paper on Significant Influence Function Review³

In December 2008, the FSA published a consultation paper entitled "The approved persons regime - significant influence function review", in which it outlined proposals to amend its Handbook in order to extend the approved persons regime. The main proposals are set out below:

- ⌚ Extending the definitions of controlled functions "CF1" (director) and "CF2" (non-executive director) to include certain individuals who exercise significant influence on a regulated firm from a parent/holding company. For example, key personnel of a group auditing committee on the basis that their decisions, opinions or actions would be regularly taken into account by the board of the authorised firm.
- ⌚ Clarifying the role of non-executive directors to make it clear that the FSA will be looking at them more closely where it considers they should have intervened more actively in a firm's management. The consultation paper includes proposed drafting specific to non-executive directors in the APER Code of Practice.
- ⌚ Extending the definition of controlled function "CF29" (the significant management function) to include all proprietary traders where they are able to exert a significant influence over a firm. The FSA considers the ability to take enforcement action for breaches of the Code of Practice and the risk of (personal) enforcement action being taken against proprietary traders may assist in deterring both senior and junior proprietary traders from undertaking activity for short term advantage that is either unauthorised, exposes the firm to risk of financial failure or jeopardises confidence in UK markets.
- ⌚ Amending the application of the approved persons regime to UK branches of overseas firms based outside the European Economic Area (EEA).
- ⌚ Extending the rule requiring previous employers to provide references for applicants of controlled function "CF30" (the customer function) to all controlled functions if requested to do so.

Consultation on the proposals closes on 31 March 2009. Thereafter, the FSA plans to finalise its proposals and publish the amended rules in a policy statement in the second quarter of 2009. The FSA is currently proposing a six month transitional period following the publication of the final rules.

Responsibilities of Approved Persons

Statements of Principle and Code of Practice for Approved Persons

Approved persons are subject to the Statements of Principle issued by the FSA and the related Code of Practice which helps to determine whether or not an approved person's conduct complies with the Statements of Principle. Both are set out in the APER Handbook.

The following Statements of Principle apply to all approved persons:

- | | |
|----------------------------------|---|
| Statement of Principle 1: | An approved person must act with integrity in carrying out his controlled function. |
| Statement of Principle 2: | An approved person must act with due skill, care and diligence in carrying out his controlled function. |

³ CP08/25 'The approved persons regime – significant influence function review' (December 2008)



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- Statement of Principle 3:** An approved person must observe proper standards of market conduct in carrying out his controlled function.
- Statement of Principle 4:** An approved person must deal with the FSA and with other regulators in an open and cooperative way and must disclose appropriately any information of which the FSA would reasonably expect notice.

The following Statements of Principle only apply to those approved to perform significant influence functions:

- Statement of Principle 5:** An approved person must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function is organised so that it can be controlled effectively.
- Statement of Principle 6:** An approved person must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function.
- Statement of Principle 7:** An approved person must take reasonable steps to ensure that the business of the firm for which he is responsible in his controlled function complies with the relevant requirements and standards of the regulatory system.

The Code of Practice provides guidance from the FSA on whether or not an approved person's conduct complies with the Statements of Principle. The Code of Practice sets out descriptions of conduct which, in the FSA's opinion, do not comply with the requirements and sets out certain factors it will consider when assessing an approved person's conduct. Approved persons should familiarise themselves with this Code of Practice to ensure that they are performing their obligations in compliance with the FSA requirements.

Detailed consideration of the Code of Practice falls outside the scope of this briefing note. However, the following should be noted:

- ⌚ An approved person will only be in breach of a Statement of Principle where he is personally culpable. Personal culpability arises where an approved person's conduct was deliberate or where an approved person's standard of conduct was below that which would be reasonable in all the circumstances.⁴
- ⌚ Disciplinary action will not be taken against an approved person performing a significant influence function simply because a regulatory failure has occurred in an area of business for which he is responsible.⁵
- ⌚ In applying Statements of Principle 5 to 7, the nature, scale and complexity of the business and the role and responsibility of the individual performing the significant influence function within the firm will be relevant in assessing whether approved persons' conduct was reasonable.⁶
- ⌚ An approved person will not be in breach of his obligations if he has exercised due and reasonable care when assessing information, has reached a reasonable conclusion and has acted on it.⁷
- ⌚ Where disciplinary action is taken against an approved person the onus will be on the FSA to show that the approved person has been guilty of misconduct.⁸
- ⌚ After ceasing to be an approved person an individual will still be accountable to the FSA. However, the FSA must not instigate proceedings after two years from the day it first knew of the misconduct. This means that even when an individual is no longer employed by a firm they continue to be liable under the regulatory regime!

⁴ APER 3.1.4

⁵ 'Action against approved persons under section 66 of the Act' in the FSA's Decision Procedure and Penalties Manual (DEPP 6.2.7)

⁶ APER 3.1.8

⁷ DEPP 6.2.8

⁸ DEPP 6.2.9



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Senior Management Arrangements, Systems and Controls (SYSC Handbook)

The SYSC Handbook requires a firm to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers in such a way that;

- ⦿ it is clear who has which of those responsibilities; and
- ⦿ the business and affairs of the firm can be adequately monitored and controlled by the directors, relevant senior managers and governing body of the firm.

The firm must allocate responsibility to one or more individuals, typically the chief executive of the firm, the functions of dealing with the apportionment of responsibility detailed above and to oversee the establishment and maintenance of systems and controls, as set out in the SYSC Handbook.

Having adequate systems and controls to ensure that a firm takes reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems, is fundamental to compliance by the firm with the regulatory framework. Failures of systems and controls is a common theme in enforcement actions brought by the FSA. Senior management are responsible for its implementation and, with the renewed emphasis on individual responsibility, effective oversight of a firm's systems and controls should be a priority.

Treating Customers Fairly (TCF)

For the last few years TCF has been a key initiative of the FSA. By the end of December 2008, all firms were expected to be able to demonstrate to the FSA **and to themselves** that they were consistently treating their customers fairly and delivering against all the TCF outcomes relevant to their business.

One of the key requirements the FSA have identified as being indicative of meeting this December deadline is that firms will have to demonstrate that senior management have instilled a culture within their firm whereby they understand what the fair treatment of customers means; they expect their staff to achieve this at all times and where (a relatively small number of) errors are promptly found by firms, put right and learned from.

From January 2009, TCF assessments formed part of the FSA's core supervisory work (i.e. assessed using ARROW, the FSA's risk-responsive operating framework) rather than a stand alone thematic review. Though previous enforcement notices demonstrate that TCF failings have already been identified during ARROW visits, we expect that TCF compliance will become more central to the ARROW agenda in the future. In the age of 'credible deterrence', where the FSA is using enforcement strategically to change the behaviour of the industry, the expectation is that there will be enforcement actions founded on breaching TCF obligations alone, as opposed to breaches of rules or other Principles. Senior management responsibility may result in individuals, as well as firms, being held culpable for these failings.

The growing prevalence of individual enforcement actions

The FSA considers that taking enforcement action against individuals is a vital part of achieving credible deterrence and has made the strategic decision to investigate more individuals on the basis that this has been proven to have a greater impact in terms of deterrence than enforcement action against firms.

As stated in our recent Enforcement Briefing, the number of individuals being held accountable for failures to comply with the Statements of Principle dramatically increased in the second half of 2008. We anticipate still greater focus from the FSA's supervisory function on the roles of individuals within firms, particularly those who carry out significant influence functions, in 2009.



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Factors the FSA take into account when deciding whether disciplinary measures against an approved person should be taken include;

- ⌚ the approved person's position and responsibility – the more senior the approved person responsible for the misconduct, the more seriously the FSA is likely to view the misconduct and, therefore, take action;
- ⌚ whether disciplinary action against the firm rather than the approved person would be a more appropriate regulatory response;
- ⌚ whether disciplinary action would be a proportionate response to the nature and seriousness of the breach by the approved person.⁹

The sanctions available to the FSA include fines, censures and prohibition orders. Prohibition orders may vary from prohibiting an approved person from carrying out a specific function in relation to a specific regulated activity to prohibiting an approved person from carrying out any function in relation to all regulated activities. The duration and extent of the prohibition order will depend on the severity of the regulatory breaches. The FSA can also use censure by issuing a public statement of the individual's misconduct or give a private warning.

We have set out below the recent enforcement actions against those carrying on significant influence functions:

- ⌚ November 2008 – The FSA banned two directors of the insurance broker, FHI (Northern) Limited for failing to ensure that their firm complied with the FSA client money rules. Both directors were prohibited for 3 years from performing any significant influence functions at firms carrying out regulated activities.
- ⌚ October 2008 – The FSA fined both Sindicatum Holdings Limited and its money laundering reporting officer £49,000 and £17,500 respectively for not having adequate anti-money laundering systems and controls in place for verification and recording clients' identities.
- ⌚ July 2008 – The FSA withdrew approval for the compliance officer (and fined the firm £35,000) at the insurance firm PMSG Insurance Services after customers were exposed to allegedly poor mortgage advice. The FSA held that the compliance officer lacked the competence and capacity to ensure that the firm met its regulatory and TCF obligations.
- ⌚ May 2008 – The FSA fined Land of Leather Limited (LOL) £210,000 for allowing its sales force to sell PPI on loans without effective monitoring or training in place to ensure that the insurance was sold fairly. The Chief Executive was fined £14,000 for failing to properly oversee the sale of PPI by LOL.

Conclusion

Never has it been more important for approved persons to understand their obligations and responsibilities within the regulatory framework. Individuals need to ensure that they are fully informed of the regulatory requirements which apply to them and take responsibility for understanding the scope of their role within the firm. The FSA has set out its stall – the implication for an approved person not meeting their obligations is much greater likelihood of individual disciplinary action than ever before. As the FSA said in its recently published Business Plan for 2009/10:

"In line with our increased focus on senior management responsibility and oversight, we expect to see more cases where individuals, especially those holding significant influence functions, are subject to enforcement action."

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⁹ DEPP 6.2.6



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