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Regulatory reference proposals hem in "rolling bad apples"

Tom Hayes, the "ringmaster" convicted of LIBOR manipulation, was a bright young trader who had worked at several banks and had valuable contacts in the finance industry. Now authorities are taking steps to stem future cultural contagion from "bad apple" staff if they "roll" to other firms. **Katharine Harle** and **Stephen Curtis** explain.

As part of the new accountability regime, the Prudential Regulation Authority and the Financial Conduct Authority have proposed to provide increased oversight of the references provided to firms when hiring for certain roles. They also seek to regulate the contents of those references. They have outlined their proposals in a joint consultation paper published in October 2015 (FCA CP15/31, PRA CP36/15).

This proposal arises out of a concern described in the Fair and Effective Markets Review (FEMR) as the "rolling bad apples" problem. The trouble is that individuals with poor conduct records (the 'bad apples') have been "recycled" between firms.

FEMR notes that this is at least in part attributable to deficiencies in references. For example, settlement agreements with employees leaving firms have often contained limits on the scope of information released in references. This is despite an existing rule that the obligation to provide a reference overrides any such agreements (in current SUP 10A.15). It appears that especially where employees are leaving under the shadow of a disciplinary investigation, in some instances these contractual limits may have allowed them to move to other firms without concerns about their conduct being revealed.

FEMR rightly notes that if so-called 'bad apples' are prevented from being able to restrict the contents of their references, then at least theoretically this should stop individuals with poor conduct records carrying that undesirable conduct to different firms. This is the broad justification for the new quite prescriptive proposals, which will (if adopted) largely be set out in a new Chapter 22 of SYSC and SUP 10A.16 in the FCA Handbook as well as new chapters in the PRA's Fitness and Propriety Rulebooks applicable to CRR firms and insurers.

The key components of the proposed new regime are explained further below.

Application of the new regulatory references regime

For the time being, these proposals will apply to candidates for:

- senior management functions (SMF) under the Senior Managers Regime (SMR);
- significant harm functions under the Certification Regime (CR);
- PRA senior insurance management functions under the Senior Insurance Managers Regime (SIMR);
- FCA insurance controlled functions;
- non-executive director (NED) roles;
- credit union NEDs; and
- key function holders (KFH) within an insurer.

Accordingly, most of the proposals apply only to so-defined Relevant Authorised Persons (that is, banks, building societies, credit unions and PRA-authorised investment firms) as well as insurers. The proposed rules define these collectively as 'full scope regulatory reference firms' (FSRRFs).

Nevertheless, some requirements apply to all regulated firms. In particular, all firms are proposed to be prohibited from entering agreements that limit their ability to disclose relevant information and subject to enhanced systems and controls requirements on keeping records as well as the policies and

procedures for both requesting and providing regulatory references. It is also notable that the current requirement on all firms to disclose all relevant information in references will continue to apply to all firms.

The key difference between the requirements that apply only to FSRRFs and those applicable to firms that are not FSRRFs, is how much prescribed information is necessary in references. Firms that are not FSRRFs are to be allowed more discretion in deciding what information is relevant to deciding the candidate's fitness and propriety.

These present two different approaches to tackling the 'rolling bad apples' problem. If the difficulty is merely that 'bad apples' have been able contractually to restrict negative information from going to new employers, the restrictive solution applying to all authorised persons should be enough. If, however, the concern is that the new employers themselves are not asking for enough information, then the prescribed information approach taken for FSRRFs is clearly more apt.

The stricter regime for the FSRRFs apparently reflects that the SMR and CR will (from March 2016) only apply to Relevant Authorised Persons. However, this seems to ignore the fact that even if a non-FSRRF does not need itself to apply the SMR, they may nevertheless have information potentially relevant to whether an applicant can perform a SMF for an FSRRF. There seems to be no clear reason why the information that must be provided is not prescribed for all firms. However, the regulators have said that they will consider whether they should later extend the specific proposals for FSRRFs to all authorised firms. This is very likely to tie in with the extension of the individual accountability regime to all financial services firms announced by HM Treasury on 14 October 2015 and which is intended to be rolled out in 2018. Therefore, this potential discrepancy is unlikely to persist for long.

Requesting references

The proposed rules require FSRRFs seeking to appoint someone to the functions listed above to take reasonable steps to obtain references covering the candidate's employment in the preceding six years.

The duty is not actually to get the references, only to take reasonable steps. This covers situations where the old employer is outside the UK or outside the regulated financial sector and therefore under no duty to provide the requested reference and may be less likely to comply. This clearly illustrates a potential gap in firms' ability to assess candidates properly. However, this is a gap that only national or European legislation requiring foreign or non-regulated firms to give references can fill, and is therefore outside the regulators' control.

In some instances, firms may need to seek a reference even where they are recruiting an individual from within their own firm or group. In all cases, firms must ask the previous employer to provide information on all matters relevant to assessing whether the candidate is fit and proper. However, where the previous employer is an FSRRF, the request for information must specify certain matters the previous employer should give information on. These matters are those that a previous employer which is a FSRRF is obliged to provide information on, as listed below and including details of the relevant functions performed by the candidate and previous breaches of conduct rules.

General rule on providing references

The proposed rules oblige all authorised firms to provide references when requested. Even though FSRRFs are required to request references from all firms, even if they are not authorised, as noted above, there is only a duty to provide references if the previous employer is an authorised firm.

As noted above, the general rule is that all authorised firms must provide references that disclose all information of which they are aware that is relevant to assessing whether the candidate is fit and proper. The regulators have said that deciding relevance is a matter for the firm, taking account of their duty under general law to exercise due skill and care in preparing the reference. None of this is new.

One issue raised by FEMR as a cause of the 'rolling bad apples' problem is that firms providing references have become afraid of their old employees suing them for negative references. They have as a result excluded information that could be relevant. The fact that many firms will continue primarily to be subject to the existing general duty to disclose all relevant information seems unlikely to address this issue especially, as it is difficult to see how the regulators will be able to identify it happening and take strong deterrent action against firms to stop this. Nevertheless, the FCA rules set out in a table certain non-binding "matters to take into account". If the regulators do carry out checks or reviews, they will be able to check that firms are providing information on these matters at the very least.

Specific rules for FSRRFs

Where the old employer is an FSRRF, the proposals set out required information and a prescribed template to provide it in.

FSRRFs must provide, as a minimum:

- Details of the relevant functions performed by the candidate and a summary of what the role involved along with its responsibilities.
- Details of any other roles performed while an employee of the firm, or as an employee of any firms within the same group, in the last six years.
- Whether the firm has decided at any point in the six years before the request for a reference that the candidate was in breach of certain conduct rules, and the facts which led the firm to that conclusion.

- Whether the firm has decided at any point in the six years before the request for a reference, that the candidate was not fit and proper to perform a function, and the facts which led the firm to that conclusion.
- Details of the basis for and result of any disciplinary action due to the two preceding points (including details such as whether they issued formal warnings or adjusted the individual's remuneration as part of that action).

These details get to the bottom of what the regulator wants firms to know before appointing individuals to the relevant functions. What did they do previously, did they do anything wrong and, if so, what was it and how serious was it?

FEMR had proposed that firms should also be required to disclose details of remuneration and training. The regulators have wisely rejected this detail to focus on requirements that seek to identify the 'bad apples'. While training may help in deciding a person's ability to carry out a role, this should be a matter for the recruitment process to assess and not part of the compulsory regime. There is a distinction between doing a job badly due to lack of training and being a 'bad apple'. It is the latter the regime seeks to stop. Nevertheless, omitting this requirement does mean that an individual could claim training and competence in particular areas while firms have no external assurance that this training was in fact undertaken satisfactorily.

Updating references

A potentially onerous new requirement is the proposed duty on FSRRFs who have given a reference after 7 March 2016 to update those references. This entails that if they become aware of matters or circumstances that mean the reference would be drafted differently from when it was given they must tell the new employer. The duty to update lasts for six years after giving the reference.

The proposed duty only applies where the differences are considered significant in assessing fitness and propriety. This therefore means the decision about significance is left to former employers. An approach more in keeping with the prescriptive style of information provided by FSRRFs would be to require the old employer to tell the new employer of any changes in the prescribed information automatically. Nevertheless, this would have greatly increased the regulatory burden on former employers and resulted in new employers having to absorb a large amount of (largely irrelevant) information. This would arguably have been disproportionate and counter-productive.

The rule applies even if the employee is no longer employed by the new employer. This therefore also puts the new employer in the position of having to update any references it has given to others, thereby ensuring that 'bad apples' cannot 'escape' their record by continually changing employers. FSRRFs will need to make changes in their procedures to ensure that any findings of misconduct in respect of former employees trigger a requirement to review and if necessary update any references given.

Amendments to prescribed responsibilities

The new accountability regime includes several prescribed responsibilities (PRs) FSRRFs must assign among their approved senior managers. The regulators have proposed to clarify that compliance with the regulatory reference rules (for both requesting and providing references) form part of some PRs, by altering their definitions. These PRs are:

- The responsibility for the firm/branch's performance of its obligations under the SMR and SIMR.
- The responsibility for the firm/branch's performance of its obligations under the employee CR.
- The responsibility for ensuring that persons who perform key functions at insurers are fit and proper.

This means that very senior individuals in firms will be personally responsible for making sure references are requested and provided in line with the requirements. This provides a valuable safeguard that FSRRFs will adhere to their duties under the regulatory references regime. All firms will need to ensure that the SMF who is proposed to hold these PRs is aware of their change in scope. For some firms it may also give cause for considering whether these responsibilities should be re-allocated.

Timing

The consultation closes on 7 December 2015. The regulators plan to amend the FCA Handbook and the PRA Rulebook in time for 7 March 2016, the commencement date for the new accountability regime.

Conclusions

The stated aim of the regulators in setting up this regime is to prevent people with poor conduct records ('bad apples') from moving between different firms without the firms they are going to being aware of those records.

To do this, they have adopted a prescriptive approach and proposed placing duties on Relevant Authorised Persons and insurers to request and provide references in a particular form. They have also stipulated what should be included in these references based on the information they consider necessary to fulfil their aims.

Nevertheless, there remain gaps and disparities in the regime. These are due both to the regulators' apparent reluctance to prescribe the content of references provided

by firms that are not FSRRFs and their inability to regulate the contents of references from unregulated and overseas firms. It remains to be seen what respondents to the consultation will make of this, especially in light of the planned extension of the SMR to all firms, and whether any significant changes will be made to the final rules as a result.

For senior managers subject to regulatory pre-approval, the opportunities for 'bad apples' to roll on under the radar from one firm to another are limited. Where the reference proposals are of most significance will be in relation to the certification staff below them. By definition these individuals' roles mean they have the capacity to cause significant harm to a firm or its customers. Before the introduction of the SMR many of these individuals would have been approved persons and subject to regulatory pre-approval. It is for these individuals that the proposals have the most work to do and where discrepancies between the duties on FSRRFs and other firms are likely to have the biggest potential impact. With those gaps likely to be closed through the extension of the SMR to all financial services firms though, the main area still open to debate is the extent to which the regulators will be able to monitor the effectiveness of the new regime properly as well as identify and take action on firms (and their accountable SMFs) who do not comply with the new requirements.

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