

Conduct Rules Scenarios

Delegation Gone Wrong

Scenario

Vanessa Jones is a director and SMF 3 of Top Fund LLP, a Core Firm.

Vanessa has responsibility for capital raising within Top Fund. However, she has also been allocated the Prescribed Responsibility for implementation of the Certification Regime under the SM&CR.

Vanessa considers implementation of the Certification Regime to be “a job for compliance”. She delegates responsibility for the matter to David Smith, the firm’s HR operative and then just ‘leaves him to it’ on the basis that ‘he is smart and will soon pick it up’. David Smith is new to the role and is not particularly familiar with the workings of the SM&CR. In particular, David does not appreciate many of the finer details around fit and proper testing such as the fact that events can trigger the need for intra-year fit and proper assessments, and the need to factor in non-financial misconduct.

As a result, there have been a number of developments among the staff that have not been taken into account during fit and proper testing. These include a salesperson failing to obtain requisite qualifications, a trader being charged for habitually failing to pay his train fare into Charing Cross station and an analyst shoplifting a chocolate bar from a local supermarket.

What conduct rules may have been breached?

- Individual Conduct Rule 2: “You must act with due skill, care and diligence”.
- Senior Manager Conduct Rule 1: “You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively”.
- Senior Manager Conduct Rule 2: “You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system”.
- Senior Manager Conduct Rule 3: “You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate individual and that you oversee the discharge of the delegated responsibility effectively”.

Points to consider

General

In order to be considered in-scope for the purposes of the Conduct Rules, the conduct in question must relate to the regulated or unregulated “financial activities” of the firm.

Under COCON 3.1.3G, a person will only be in breach of a Conduct Rule where they are personally culpable. In other words, the person’s conduct must have been:

1. Deliberate, or
2. Below the standard of conduct that would be reasonable in all of the circumstances.

Pursuant to COCON 3.1.2G, in assessing whether a breach of the Conduct Rules has occurred, the FCA will have regard to the context in which a course of conduct was undertaken, including:

1. The precise circumstances of the individual case,
2. The characteristics of the particular function performed by the individual in question, and
3. The behaviour expected of that function.

The FCA will also take into account whether the conduct in question (a) relates to activities that are subject to other provisions of the FCA Handbook, or (b) is consistent with the requirements and standards of the regulatory system (as far as it applies to the firm).

Pursuant to COCON 3.1.5G and 3.1.6G, in determining whether a breach of the Senior Manager Conduct Rules has occurred, the FCA will take into account:

1. Whether the Senior Manager exercised reasonable care when considering the information available to them,
2. Whether the Senior Manager reached a reasonable conclusion upon which to act,
3. The nature, scale and complexity of the firm’s business (the smaller and less complex the business, the less detailed and extensive the systems of control in place need to be – and vice versa),
4. The role and responsibility of the Senior Manager as determined by reference to his/her Statement of Responsibilities, and
5. The knowledge which the Senior Manager had, or should have had, of regulatory concerns (if any) relating to their role and responsibilities.

In terms of the territorial application of the Conduct Rules, in general the Conduct Rules only apply to ‘UK activity’. More specifically, the Conduct Rules apply to:

1. Conduct performed from an establishment maintained in the UK by a firm which is subject to the SM&CR, or
2. Conduct which involves dealing with a UK-based client of a UK firm which is

subject to the SM&CR from an establishment overseas.

However, the Conduct Rules apply to the conduct of the following individuals wherever it is performed:

1. A Senior Manager, or
2. An employee of an SM&CR firm who performs the function of a Senior Manager, or
3. A non-executive director, or
4. A Certification Employee who performs Certification Function (6) (“Material Risk Taker”).

Ultimately, the firm will have to notify the FCA of any breach of the Conduct Rules. Normally, breaches of the Conduct Rules by non-Senior Managers must be notified to the FCA annually in October using Form H (also known as “REP008 – Notification of Disciplinary Action”). However, the following types of breaches must be reported to the FCA “immediately”:

1. Any “significant” breach of a Conduct Rule (SUP 15.1.7G(1) and SUP 15.3.11R(1)(a)), or
2. Any matter that could have a significant adverse effect on the firm’s reputation (SUP 15.3.1R(3)), or
3. The occurrence of any fraud with respect to any member of staff (SUP 15.2.17R).

The FCA must be notified of any breach of the Conduct Rules by a Senior Manager within 7 days, pursuant to SUP 10C Annex 2G.

Vanessa

Individual Conduct Rule 2 requires individuals to ‘act with due skill, care and diligence’. In the case of someone who holds a managerial position (note that this does not have to be a Senior Manager) the rule requires that individual:

1. To understand and inform themselves about the business sufficiently to understand the risks associated with its business activities,
2. To take reasonable steps to ensure that the business of the firm for which the manager has responsibility is controlled effectively, complies with regulatory requirements and has implemented effective delegation of responsibilities.

Where a manager is not an expert in a particular business area, they should consider whether they (or those with whom they work) have the necessary expertise to provide an adequate explanation of any issues that arise within that business area.

Insofar as it relates to managers, there is significant overlap between **Individual Conduct Rule 2** on the one hand, and **Senior Manager Conduct Rule 1**, **Senior Manager Conduct Rule 2** and **Senior Manager Conduct Rule 3** on the other hand.

Senior Manager Conduct Rule 1 requires Senior Managers to ‘take reasonable steps to ensure that the business of the firm for they you are responsible is controlled effectively’. Clear reporting lines are key (particularly where dual reporting lines exist). In addition, Senior Managers must take reasonable steps to satisfy themselves that the business for which they are responsible has appropriate policies and procedures in place for assessing the competence, knowledge, skills and performance of members of staff.

Vanessa has effectively just ‘dumped’ responsibility for implementation of the Certification Regime on David, despite the fact that he works in a different department and has no experience in this area. In effect, she has created a dual reporting line for David. As such, she is responsible for ensuring David’s responsibilities and accountabilities are clearly set out and understood. On the facts as we have them, she has not done this. More fundamentally, there seems little evidence that Vanessa has take any steps to satisfy herself that David actually has the knowledge, skills or capacity to effectively implement the Certification Regime within Top Fund LLP. Put simply, there is no evidence that David is an appropriate delegate for a role like this. Quite the opposite, the evidence at hand would suggest that he is not.

Senior Manager Conduct Rule 2 requires Senior Managers to ‘take reasonable steps to ensure that the business of the firm for which they are responsible complies with the relevant requirements and standards of the regulatory system’. Under this Conduct Rule, Senior Managers are required to take reasonable steps to ensure that operating procedures and systems exist which promote compliance with regulatory requirements and ensure that the business is run prudently. Where actual or suspected breaches of regulation become apparent, Senior Managers should take reasonable steps to ensure that they are dealt with in a “timely and appropriate manner”.

A failure to (a) implement an “adequate and appropriate” system of control (or to keep it under regular review), (b) monitor regulatory compliance, or (c) investigate the root causes of regulatory breaches are all considered by the FCA as a breach of **Senior Manager Conduct Rule 2**.

In reality, Vanessa really does not see implementation of the Certification Regime as her responsibility. She has not implemented any controls, instead leaving implementation in its entirety to David. A number of issues around the fitness and propriety of various members of staff have arisen, but Vanessa has taken no interest in this and done nothing to monitor or review either these breaches or the systems and controls that exist to prevent this. Put simply, Vanessa has allocated the task of implementing the Certification Regime to David and not subsequently followed up in any way, shape or form. On this basis, it seems impossible to conclude that she has taken reasonable steps to ensure that the business of the firm for which she is responsible complies with regulatory requirements.

Senior Manager Conduct Rule 3 requires Senior Managers to ‘take reasonable steps to ensure that any delegation of responsibilities is to an appropriate individual and that the discharge of the delegated responsibility is overseen effectively’.

Whilst delegation is permissible, a Senior Manager must have reasonable grounds for

believing that a delegate has the competence, knowledge, skill and time to deal with the matter that is delegated, BEFORE the delegation takes place. A Senior Manager must maintain “an appropriate level of understanding” about the issue that has been delegated and continue to monitor and supervise the individual to which delegation was made. Disregarding an issue after it has been delegated, or not obtaining “adequate” reports about an issue which has been delegated, would be regarded as a breach of **Senior Manager Conduct Rule 3**.

Vanessa should bear in mind that, whilst she can delegate the tasks associated with implementation of the Certification Regime, she cannot delegate RESPONSIBILITY for making sure that the Certification Regime has been properly implemented. Unfortunately, her initial choice of David – someone with no background in implementing the Certification Regime – is entirely inappropriate.

Even if David had been a suitable candidate, Vanessa’s complete lack of ‘follow up’ would constitute a breach of **Senior Manager Conduct Rule 3**. Vanessa must take all necessary steps to ensure that the implementation is overseen properly and that she has all of the necessary MI to monitor risks and exercise control.

Put simply, it is Vanessa’s responsibility to ensure that the delegation to David is both appropriate and effective. She should have ensured that David and the HR team more generally understood the Certification Regime properly, were provided with sufficient resources, implemented correct fit and proper testing, and kept the situation under periodic review and monitoring.

It is questionable whether the Prescribed Responsibility for implementation of the Certification Regime should have been allocated to Vanessa in the first place given Vanessa’s attitude to the matter. In turn, this may raise questions over the role of the Senior Manager with responsibility for implementation of the Senior Managers Regime within Top Fund LLP. He or she should have ensured that Prescribed Responsibilities were allocated appropriately. This seems not to have been the case where Vanessa is concerned.

More generally, Vanessa’s attitude to compliance actually raises the wider question of whether she is a suitable candidate to be a Senior Manager in the first place.

The Senior Manager(s) with responsibility for implementation of the various aspects of the SM&CR may also have some additional liability under this scenario. There seems to be evidence suggesting that Top Fund’s Senior Managers have not been trained on the importance, role and implementation of the SM&CR, particularly the Certification Regime and the Conduct Rules.