Corterum

Conduct Rules Scenarios
The NED With Concerns

Scenario

James is a non-executive director and Chairman of Trusty Brokers Ltd.

Trusty Brokers Ltd is owed by a venture capital firm. Keen to see a return on its investment, over the past year, the venture capital firm has been increasing the pressure on Trusty Brokers Ltd to grow revenue.

Trusty Brokers Ltd is due to embark on a push to expand. As part of this push, it plans to introduce a new incentive plan for its salesforce. The plan involves paying salespeople 7 years' worth of sales credits upfront for sales of products to new customers. Sales credits are particularly high with respect to a new type of higher-risk product (on which Trusty Brokers Ltd receives a higher commission). There are no provisions allowing sales credits to be 'clawed-back' in the event that a customer redeems an investment early.

James is concerned about the new incentive plan for a number of reasons. Firstly, he believes that it will create bad incentives for salespeople generally and may result in the firm selling products to clients which are unsuitable to their financial requirements. Secondly, he is concerned that, whilst the salesforce will certainly be incentivised to assist with the expansion of Trusty Brokers Ltd, that expansion may be built on weak foundations which will ultimately come back to 'bite' the firm. Finally, he sees no evidence of additional controls having been put in place to support the expansion.

James raises his concerns with Christine, Head of Sales for Trust Brokers Ltd, an SMF 3 and the person who has developed the incentive plan. Christine is quite dismissive of James' concerns. She is adamant that her incentive plan is the only way to proceed and that James shouldn't be such a "worry wart".

Gary, the Chief Executive Officer and SMF 1, is noticeably quiet about the whole situation. James suspects that this is because his compensation from the venture capital firm is linked to revenue growth at Trusty Brokers Ltd.

What conduct rules may have been breached?

- Individual Conduct Rule 1: "You must act with integrity".
- Individual Conduct Rule 2: "You must act with due skill, care and diligence".
- Individual Conduct Rule 4: "You must pay due regard to the interests of customers

and treat them fairly".

- 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 4: "You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice".

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.

James

We can assume that James holds the position of SMF 9 (Chair).

There is no suggestion that James is doing anything that might be in breach of the Conduct Rules. He has concerns and is presenting those concerns to the appropriate individuals within Trusty Brokers Ltd. In this sense, his actions and conduct are consistent with the expectations of the FCA as expressed in COCON 1, Annex 1 (Guidance on the role and responsibilities of non-executive directors of SMCR firms).

Unfortunately for James, his concerns do not appear to being taken sufficiently seriously by the executive board.

In these circumstances, what can James do?

All non-executive directors should be able to challenge the decisions of the executive board. James should remind the board of this fact and ensure that the minutes of any board meetings accurately reflect discussions on this matter. If James feels that his concerns are not being taken seriously or adequately addressed, he should consider whether it is necessary to resign his position. If he does, he should consider informing the FCA of the reason why he has felt necessary to resign. Doing so would likely be regarded as being consistent with his obligations under **Senior Manager Conduct Rule 4** ("You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice").

If Gary (the Chief Executive Officer) refuses to take James' concerns seriously, it may be advisable for James to raise his concerns with the Senior Manager who has the Prescribed Responsibility for implementation of the Senior Managers Regime. That person should understand the importance of the executive board taking on board the concerns of any non-executive directors and remind the board of their own obligations under the SM&CR.

<u>Christine and Gary</u>

Christine and Gary are at greater risk of breaching the Conduct Rules than James.

Individual Conduct Rule 1 requires individuals to 'act with integrity'. The FCA provides a non-exhaustive list of examples of conduct that would constitute a breach of **Individual Conduct Rule 1**. This includes:

1. Misleading others in the firm about the nature of risks being accepted,
2. Not paying due regard to the interests of a customer, and
3. Act, omissions or business practices that could be reasonably expected to cause customer detriment.

James has expressed concerns that the new incentive plan for Trusty Brokers Ltd could create inappropriate incentives for the salesforce – particularly with respect to the sale of higher-risk products which may not be suitable for all clients. He has also expressed concerns that, in the longer term, the new incentive plan could actually threaten the stability of Trusty Brokers Ltd itself. If Christine and Gary continue to dismiss/ignore the concerns of James – without any attempt to justify why and in light of the focus on out-and-out revenue growth – it is difficult to see how they could be regarded as acting with integrity.

James has concerns that the new incentive plan could create poor outcomes for clients as it encourages the salesforce to promote products that are higher-risk and therefore only suitable to more sophisticated investors. **Individual Conduct Rule 2** and **Individual Conduct Rule 4** become relevant in this regard.

Individual Conduct Rule 2 requires individuals to 'act with due skill, care and diligence'.

Recommending an investment to a customer, or carrying out a discretionary transaction for a customer where the advisor does not have reasonable grounds to believe that it is suitable for that customer is an example of conduct that would be a breach of **Individual Conduct Rule 2**. The FCA provides further guidance to Conduct Rules individuals who, like Christine and Gary, are managers. In particular, the FCA makes clear that they should investigate and satisfy themselves, on reasonable grounds, about the risks involved in expanding the business into new areas – before the expansion actually takes place.

In raising his concerns to both Christine and Gary, James has effectively served warning on both that the new sales incentive plan risks creating poor outcomes for clients. Given that Trusty Brokers Ltd intends to begin selling new types of products, if Christine and Gary simply ignore James' concerns, it is difficult to see how they could be regarded as being compliant with **Individual Conduct Rule 2**.

In a similar vein to **Individual Conduct Rule 2**, **Individual Conduct Rule 4** requires individuals to 'pay due regard to the interests of customers and treat them fairly'. Among the list of examples of conduct that the FCA regards as being in breach of **Individual Conduct Rule 4** is 'recommending an investment to a customer, or carrying out a discretionary transaction for a customer, where they do not have reasonable grounds to believe that it is suitable for that customer'. It is incumbent upon both Christine and Gary to address James' concerns if they wish to reduce the risk that they may end up in breach of **Individual Conduct Rule 4**.

Senior Manager Conduct Rule 1 requires Senior Managers (such as Christine and Gary) to 'take reasonable steps to ensure that the business of the firm for which they are responsible is controlled effectively'. In this regard, the FCA specifically warns that, if the strategy of a business is to enter high-risk areas, then the degree of control and strength of monitoring reasonably required within the business will be high. The lack of additional measures within Trusty Brokers Ltd to control the risks associated with the expansion into new product lines is likely to render both Christine and Gary in breach of **Senior Manager Conduct Rule 1**. Put simply, they should stop and listen to James.

The conduct of both Christine and Gary can be view as deliberate. At the very least, it can be regarded as 'falling below the standard of conduct that would be reasonable in all of the circumstances'. Either way, both Christine and Gary would seem to satisfy the 'personal culpability' requirements of COCON 3.1.3G and so would be liable for any breach of the Conduct Rules.

As both Christine and Gary are Senior Managers, the FCA must be notified of any breach of the Conduct Rules within 7 days, pursuant to SUP 10C Annex 2G.