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### Jacqueline Jones examines the implications of the FSA's latest initiative on approved persons and controlled functions

Sweeping changes announced by the FSA will have a considerable impact on Board Directors and proprietary traders.

This follows events in 2007, when the FSA's senior executive commissioned an Internal Audit review of lessons learned from its supervision of Northern Rock. Recommendations from that report were published in March 2008, and in response to those recommendations and other initiatives, The Supervisory Enhancement Programme was established to implement those improvements. The recommendations included:

This recommendation specifically mentioned a focus on increasing the thoroughness of FSA's supervision where issues regarding the competence of firms' management were identified. As a result, FSA reviewed its approach to the significant influence controlled functions to see where improvements could be made and to examine whether the regime reflected corporate governance structures within the industry.

The FSA has already made a number of changes in its approach to significant influence controlled functions as a result of its review, for example interviewing more of those applying to undertake significant influence functions at the largest firms. The latest Consultation Paper sets out further changes which would require amendment to the FSA Handbook.

FSA Consultation Paper (CP) 08/25 is entitled "The approved persons regime - significant influence function review".

Previously, for individuals holding significant influence controlled

functions, the FSA has tended to focus on cases of dishonesty or lack of integrity, where prohibition or withdrawal of approval was the most appropriate outcome.

This increased scrutiny of senior staff competence, including particularly that for non-executive directors (NED), falls within the regulator's efforts to achieve what it calls "credible deterrence".

The FSA has stated that it will be looking with sharper focus at NEDs of firms, if it believes they should have "intervened more actively with a firm's management" – see below.

As part of this work, the FSA has already started to interview more applicants for "significant influence" posts at high impact firms. Once in post, where individuals fail to meet the required standards, the FSA will consider enforcement action.

The CP proposes to:

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The CP proposes to:

- extend the definition of the existing CF1 (director) and CF2 (non-executive director) controlled functions to include certain individuals in parent companies to which an authorised firm is accountable;
- clarify the role of NEDs to make clear that the FSA will, in future, look at non-executives more closely where it believes they should have intervened more actively with a firm's management;

- extend the definition of CF29 (significant management function) to include all proprietary traders;
- amend the application of the approved persons regime to UK branches of overseas firms based outside the EEA; and
- extend the rule obliging firms to provide references for applications of the CF30 (customer function) to all controlled functions if requested to do so.

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In a speech given by Sheila Nicoll, Director of the Retail Firms Division of the FSA in September 2008, she addressed an audience of NEDs on the subject of good risk management and its vital role in what she termed "survivability".

The clear message was that the FSA sees good governance as being at the heart of good risk management because it is only through having good governance in place that a firm is likely to be both willing and able to face up to its key risks. Much has been written about governance systems and processes, but it really all comes down to the people. Without the right people in key roles, even the best processes cannot be expected to function effectively. This speech was important in that it seemed to set the scene for the proposals announced in the latest CP.

Ms Nichol went on to say that the main way the FSA assesses the governance arrangements and key aspects of the firm's control environment is an on-site risk assessment programme – in other words an ARROW visit. It is interesting to note the types of discussion she mentioned as probably taking place during these visits, particularly with NEDs.

The FSA will routinely speak to NEDs, particularly if they chair a key committee, such as the Audit Committee or Compliance Committee. Although it expects its discussions with

non-executives to be wide-ranging, given the important role they play, it should be noted that it does not expect a detailed, executive view of all operations. Instead, FSA supervisors are more interested in the NEDs' perceptions of the firm and what steps they would take to satisfy themselves that risks are identified, measured, monitored and controlled.

In these visits, the FSA will tackle such issues as:

- whether the directors, and their fellow non-executives, have a good oversight of the risks facing the firm;
- how effective the controls are within the firm;
- the adequacy of the firm's infrastructure, including whether the firm's people know within which legal entity inside a group they are operating; and
- what controls there are in place to ensure that business is conducted properly with customers and markets.

The FSA will look at the quality of risk assessment and planning, and if it feels that the governance structure is not good enough, it will expect the firm to take action to rectify this. For example, in past cases it has asked for changes where there were insufficient NEDs on the Board, or where the calibre, expertise or skills of the NEDs were not good enough. It will exert pressure on executive management to ensure the quality of NEDs. Conversely it expects those NEDs to challenge the executive, where appropriate. The publication of the latest CP shows just how seriously the FSA will be taking these issues - particularly those related to competence - not just those related to dishonesty or lack of integrity.

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Non-executives should be assisting executive colleagues in setting and monitoring the firm's strategy and should scrutinise the management's approach, the firm's performance and standards of conduct, as well as carrying out other responsibilities assigned by the board.

Under the new rules, individuals in the parent or holding company whose



decisions, opinions or actions are regularly taken into account by the board of the authorised firm would need to be registered with the FSA as approved persons. Examples might include key members of a group's audit or remuneration committee.

Firms should concentrate on undertaking proper due diligence checks when appointing senior people, and as a further safeguard, should keep proper documentation of their vetting process in case they need to justify their decision on a particular applicant.

Firms should have in place a clear programme demonstrating how they will assess initial competence of NEDs and senior managers, and also monitor ongoing competence. It would be advisable also to have in place a sound strategy of Continued Professional Development for senior executives and NEDs.

They should also be aware that this new process will introduce delays to the deployment of senior managers and plan accordingly.

Remember that the other significant amendment in the CP proposes to extend the rule obliging firms to provide references for applications of the CF30 (customer function) to all controlled functions if requested to do so. With this amendment the FSA is closing a gap in the referencing for approved persons.

Remember also that the FSA considers that its vetting process is not intended to be a substitute for a firm undertaking proper due diligence itself - responsibility for this still lies with a firm's senior management.

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Smaller providers should be aware that these measures apply equally to them as well as large financial services groups.

The consultation period closes on 31 March 2009. The FSA will then finalise the proposals and publish revised rules in a Policy Statement during the second quarter of 2009.

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