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CP08/25 – The Approved Persons regime: significant influence function review

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The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of FSA Consultation Paper 08/25 has been prepared by the CLLS Regulatory Law Committee. Members of the Regulatory Law Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisors, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

Introductory comments

Before turning to FSA's nine questions we wish to make a preliminary observation, which is that FSA has failed to establish an adequate case for any of the proposed handbook amendments. While we appreciate the purpose underlying the existence of the approved person regime in its current form, FSA needs to justify the proposed changes by reference to some market failure – in other words, to explain why the current regime is inadequate. We acknowledge that FSA may have concerns over the role of the ultimate holding company of an FSA authorised firm in circumstances where FSA does not regulate the holding company, and that these concerns may have been brought into sharp focus during the recent financial instability and are, indeed, discussed in the recent DP 09/2. However, it is unsatisfactory for the reader to have to guess at FSA's reasoning rather than to have it properly laid out. If FSA does indeed have such reasons, it has not included them in the Consultation Paper and the Cost Benefit Analysis is therefore inadequate because, inconsistently with FSA's Policy Delivery Standards, there is no such explanation.

One justification that FSA raises for these changes in CP 08/25 is the outcome of the Northern Rock investigation. We are aware of the conclusions of the review by FSA Internal Audit of the quality of FSA's supervision of Northern Rock, but it is not easy to associate any of FSA's proposed changes with the recommendations that that report contained. We further understand that FSA seeks to increase the rigour of its day-to-day supervision pursuant to its "Supervisory Enhancement Programme" (SEP), but nobody knows whether it contains sufficient reasons to support these changes because FSA has not chosen to publish it.

In particular, it seems that none of the CP's recommendations relate directly to the competency of firms' management, which is stated to be a recommendation of the SEP. Instead, the main focus appears to be on "whether the regime reflect[s] corporate governance structures within the industry", which is a separate issue. In this respect FSA states (at 3.3) that while the current regime reflects the fact that a firm may be managed on function, product or matrix basis, it

> "does not necessarily reflect the increased significant influence exerted on an authorised firm by individuals based in parent undertakings or holding companies to which the authorised firm is accountable".

This is a surprising justification for a significant change because

- A statement that the present regime should be changed because "it does not necessarily reflect" a situation is a weakly formulated case; and

- FSA says nothing in support of the key justification for this change, which is that this kind of significant influence "has increased".

Instead, it seems to this Committee that this kind of influence has always been present, was taken into account by Parliament in passing the FSM Act in 2000, and was also within the understanding of FSA when devising the APER handbook in 2001.

Turning to the subsequently published DP 09/2, we note how FSA advances arguments (at paragraph 6.7 onwards) for the extension of regulation over currently unregulated companies within groups containing regulated firms. We do not now propose to comment on this, but would point out that FSA's concerns expressed in DP 09/2 do not justify the changes proposed in CP 08/25 because

> (i) They are addressing the regulation of firms rather than of individuals;
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> (ii) They call for legislative rather than rulebook change (6.11); and
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> (iii) FSA recognises that global and consistent implementation is required, which is the antithesis of what CP 08/25 is seeking (6.14).

LIST OF QUESTIONS AT ANNEX 2 in CP08/25

Q1: Do you agree with our proposal to extend controlled functions CF1 (director) and CF2 (non-executive director) to those individuals exercising significant influence?

No we do not. Aside from the point mentioned above that FSA has produced no adequate reasons in support of this proposed policy change, we have the following points.

1. It seems to us that the proposed extension of APER falls outside FSA's powers. Section 59(1) FSM Act states as follows (with our emphasis added)

> **59 Approval for particular arrangements**
>
> (1) An authorised person ("A") must take reasonable care to ensure that no person performs a controlled function under an arrangement entered into by A in relation to the carrying on by A of a regulated activity, unless the Authority approves the performance by that person of the controlled function to which the arrangement relates.

And "arrangement" is defined as

> (10) "Arrangement"--

(a) means any kind of arrangement for the performance of a function of A which is entered into by A or any contractor of his with another person; and

(b) includes, in particular, that other person's appointment to an office, his becoming a partner or his employment (whether under a contract of service or otherwise).

Let us explore this proposition by taking one of the examples cited by FSA, a director of a holding company (PLC) who has involvement in the FSA-authorised firm's (Firm) decision taking (Draft SUP 10.6.5 (2)). In this case it is apparent that the Firm has not entered into any arrangement with that individual. The individual is a director of PLC by reason of arrangements entered into by PLC, not the Firm, and those arrangements cannot properly be attributed to the Firm. Furthermore, any involvement that he may have in the Firm's decision taking arises from (i) the position that he holds as a director of PLC and (ii) the fact that PLC has subscribed for shares in the capital of the Firm. This issue of shares is not "an arrangement entered into by A in relation to the carrying on by A of a regulated activity" and, even if it were, the individual's involvement in the Firm's decision taking is not being performed "under" that shareholding.

FSA will further note that the "arrangement" has to relate to the performance of a function of the Firm. Thus, even if an arrangement under which the director of PLC is consulted on decisions that are being made in respect of the management of the Firm amounts to an "arrangement entered into by A" (which we consider is not the case), the arrangement relates to the performance of a PLC function and not the performance of a function of the Firm for which the director has no responsibility. The fact that a director of PLC is involved in the Firm's decision making, or that his decisions or opinions are taken into account by, or even exercise significant influence over, the Firm does not satisfy the statutory test because none of this means that he has become responsible for the performance of any of the functions of the Firm.

As a statutorily defined word, it is not open to FSA to vary the meaning of "arrangement", or to seek to interpret its meaning so as to extend it to a wider class of arrangements than those contemplated by Parliament.

2. We note that FSA proposes to apply the extended CF1 and CF2 to individuals in regulated and unregulated UK parent undertakings and holding companies; regulated and unregulated third country parent undertakings and holding companies; and EEA unregulated parent undertakings and holding companies, but not UK branches of an EEA regulated company, nor UK incorporated authorised firms with an EEA regulated parent company. (3.10, 11) FSA should explain whether this is the case because it is satisfied that individuals working for regulated EEA firms are acceptable as persons exercising influence over UK subsidiaries, or whether it recognises that it is prevented from extending the approved person regime over them by the force of EU law. If the latter, FSA should explain why it is appropriate to introduce this additional requirement on UK authorised holding companies when not applicable to their EEA counterparts.

3. The proposal is to extend the definitions of CF1 and CF2 to include individuals whose decisions, opinions or actions are regularly taken into account by the governing body of the authorised firm. Unlike the other controlled functions, whose applicability can be determined with relative ease, this is unsatisfactorily vague. A firm is entitled to know whether an individual falls within or outwith the scope of individual approval, but this definition means that a firm will need to ascertain whether

   a. The individual's opinions etc are taken into account by its board. Is FSA envisaging that if there are 10 members of PLC's board that vote to approve the

Firm's budget, all 10 members have taken a decision that will be taken into account by the Firm's board? Or just the Chairman? Or the Group Finance Director who works alongside the Firm in implementing the budget?

b. Whether this is a regular occurrence. Does this mean that PLC's approval of the Firm's annual budget will fall outside the scope of individual approval, whereas approval of a quarterly budget would not? What if the Firm is in a financial crisis and PLC's board meets weekly to monitor its performance and provide capital support? Does FSA suggest that this would contribute the element of regularity so that none of the PLC board members could so act until first approved by FSA?

The proposal that firms' corporate governance arrangements should identify where individuals in parent undertakings and holding companies are exercising a significant influence on the authorised firm, and that FSA will examine corporate governance arrangements to see if they sufficiently identify where significant influence lies is inadequate because, unless FSA clarifies its requirements, it is unreasonable to expect a firm to be able to identify who is affected.

4. There are some further practical difficulties surrounding this proposal as follows:

a. A Firm will not necessarily possess sufficient information about an affected individual to provide to FSA to enable it to conclude that he is fit and proper in accordance with section 61 FSM Act.

b. FSA may itself not possess sufficient information to enable it to reach this conclusion, especially in relation to familiarity with the UK regulatory system.

c. If FSA refuses individual approval, it will not necessarily be within the power of the Firm to require the individual to desist from those activities that it (or FSA) considers bring him within the scope of the amended rule.

5. If this proposal is implemented, it will extend FSA regulation to senior managers of unregulated firms who are not otherwise subject to UK regulation and who have no direct responsibility for the management of those firms. The obligations arising from individual FSA approval as a person holding a significant influence position do not correspond to the role performed by a manager working for an unregulated firm who may influence, but holds no office in, a UK regulated subsidiary. It is impracticable for FSA to impose this requirement on an individual who has no executive role in a regulated firm. Furthermore, the imposition of APER 5 – 7 appears to be disproportionate and impracticable because they in essence require an individual registered as CF 1 or 2 to ensure that the firm is being run compliantly. In particular

a. APER 2 requires an approved person to act with due skill, care and diligence in carrying out his controlled function. How will FSA judge whether the individual's intermittent and by definition informal involvement in some aspect of the UK firm's affairs fulfils this criterion?

b. APER 5 requires an approved person performing a significant influence function to 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. An affected individual is unlikely to be responsible for any business of the firm and, furthermore, possesses no authority to enable him to organise any aspect of it.

c. APER 6 requires an approved person performing a significant influence function to exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his controlled function. An affected individual is unlikely to have authority for managing any aspect of the business of the firm.

d. APER 7 requires an approved person performing a significant influence function to 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. Yet again, an affected individual is unlikely to be responsible for any business of the firm and, furthermore, possesses no authority to enable him to organise any aspect of it.

6. If FSA does proceed with this proposal, then unregulated holding companies may need to reconsider their method of operating, possibly changing the roles of individuals working in holding companies so that they plainly fall outwith FSA's definitions. This would be a regrettable step to have to take, because it would deprive the regulated firm of the benefit of group oversight that has so far proved beneficial and in respect of which FSA has not demonstrated that it has any sound objections.

7. The implementation of this proposal will also create conflict with directors' fiduciary duties, which are generally understood as being owed exclusively to the company of which they are director. This is because requiring a person who is *not* a director of Firm to agree to be bound by APER 5 – 7 in relation to Firm will, in addition to being impracticable (as explained at 5), cut across the fiduciary duties owed by those persons who actually *are* the directors of Firm – are they obliged to accept his actions taken in purported discharge of APER 5 – 7 even though he is not a director and their fiduciary duties may point to a different conclusion? Moreover, if that individual is a director of PLC, his newly imposed obligations towards Firm will place him in a further position of conflict with regard to the fiduciary duties that he owes to PLC in that his duty to PLC may conflict with his FSA-imposed duties towards Firm.

8. FSA should also consider the effect of implementing this proposal from the perspective of an affected overseas regulator. Taking the example of a Canadian holding company and its UK FSA-authorised subsidiary, let us assume that certain executives of the Canadian holding company, who have no office in the UK firm, are viewed as exercising significant influence over it and are thus required to become CF2s. This would then raise the issue of the Canadian regulator losing an element of oversight over the group because the regulator of a subsidiary is seeking to impose direct obligations on head office officials which cut across the corporate structure of the group and fetter the lead regulator's exclusive oversight over their activities.

Q2: Do you agree that a transitional period of 6 months is sufficient for implementation?

We make no separate comment on this point.

Q3: Do you agree with our proposed guidance to the Handbook that clarifies the role of non-executive directors?

We do not agree that this clarifies the role of a non-executive director because it is not otherwise unclear. Nor do we feel it is necessary to include this material. There is a considerable volume of material freely available that addresses the duties of non-executive directors from, among others, the Institutes of Chartered Accountants and Institute of Directors. Material of this kind is openly debated and periodically revised, reflecting new approaches and developments. We see little benefit to be gained from FSA producing a summary definition that seeks to compress these duties into a few

bullet points and which will lack the dynamic character of other respected and widely available commentaries.

Q4: Do you agree with our proposal to extend the description of CF29 to include more proprietary traders?

No, because FSA has no power to do this. Section 59 FSM Act states that

(4) The Authority may specify a description of function under subsection (3) only if, in relation to the carrying on of a regulated activity by an authorised person, it is satisfied that the first, second or third condition is met.
(5) The first condition is that the function is likely to enable the person responsible for its performance to exercise a significant influence on the conduct of the authorised person's affairs, so far as relating to the regulated activity.

FSA cannot reasonably conclude that *every* proprietary trader has this power – "likely" falls short of "probably" but cannot be equated with "potentially". If only some traders will be caught, then the objection arises that FSA should not introduce a rule that is vague and the interpretation of which will necessarily be subjective. An FSA rule should be clear so that firms and individuals can judge for sure whether or not they are acting in compliance.

Moreover, if a proprietary trader is to remain (as at present) outwith the APER regime, his or her activities are nonetheless caught by SYSC and fall within GENPRU/BIPRU and the Code of Market Conduct so there is no question that a firm is not required to have full controls over their activities and maintain adequate capital in respect of their positions, or that the individual is not liable to prohibition in serious instances of market misconduct.

Lastly, and as FSA has recognised in its earlier consultations, the introduction of this proposal could have seriously anti-competitive consequences for UK firms. This is because while FSA can choose to apply this proposal to UK and non-EEA firms, it is powerless to do so in relation to the UK branches of EEA-passported firms. This would give rise to a comparative disadvantage for UK firms and might result in firms with EEA operations restructuring their trading desks simply to avoid this additional burden.

Q5: Do you agree with our judgement that the proposed guidance in the draft handbook text (Appendix 1) supports the expectation that all proprietary traders will be approved persons?

We make no separate comment on this point.

Q6: What are your views on the outcome of the cost benefit analysis compared to other reasons why we might implement this proposal?

We make no separate comment on this point.

Q7 Do you agree that a transitional period of six months is sufficient for implementation?

We make no separate comment on this point.

Q8: Do you agree that we should remove the limited application of the approved persons regime to UK branches of third country firms?

We make no comment on this point.

Q9: Do you agree that we should extend the reference requirement in SUP 10.13.12R so it applies to all controlled functions?

We make no comment on this point.

Yours sincerely

Margaret Chamberlain
Chair CLLS Regulatory Law Committee

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