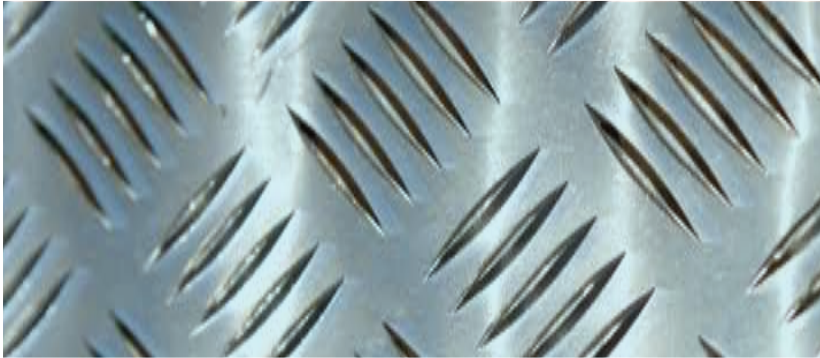


Intensive and Intrusive Supervision: Missives and missiles from the UK regulator



“The ‘new’ regime, insists Mr Sants, will ensure that ‘Individuals seeking to hold significant influence positions...are both technically equipped and demonstrate the required integrity.’”

Recently, the Chief Executive of the Financial Services Authority Hector Sants felt moved to add to the naval gazing currently bedeviling the city with an apologia for his organisation’s workings, current and, indeed, future, and provide further explication of its philosophy de jour.

The tone of Mr Sants speech certainly warrants close consideration particularly when it also declares an increasing focus on the ‘fit and proper’ regime. This, together with its ‘judgements on judgements’, the FSA seemingly gives notice of its reinvention as moral guardian of the financial services and presents a challenge to all who do not wish to be a casualty in the FSA’s battle for survival.

→ Cultural shift

In a speech by Hector Sants on 9 November 2009, he noted that “There are two principal tools at the disposal of the regulator to influence culture: governance systems and people.”

Further, “Going forward, we will be seeking to identify mechanisms for assessing the effectiveness of culture during our risk review process. This would certainly include when assessing board effectiveness... However, I believe the key enabler should be our ‘fit and proper’ regime.”

Whereas previously firms needed to demonstrate the existence of appropriate governance arrangements, Mr Sants is suggesting that their new objective will be to determine whether the actions of senior management are appropriate in the context of the risks undertaken.

→ Judgements on judgements

“The FSA has moved firmly into the realm of making ‘judgements on judgements’” warns Mr Sants. “This is different from how we operated in the past.”

“In the past, the FSA was primarily reactive... and adhering to the view that it should leave management to make its own decisions.

Intensive supervision, in contrast, focuses on the risks inherent in a firm’s business model and enables us to be proactive... to the management of these risks.”

Mr Sants accepts the potential tensions this may present and again repudiates the ‘light touch’ mantra which had, hitherto, been the keystone of the regulator.

→ Intensive supervision

Central to the Intensive supervision approach, is reform of the authorisation and significant influence regime. This, believes Mr Sants, is part of the response that seeks to remedy the “absence of the acceptance of collective responsibility...” for the financial crisis.

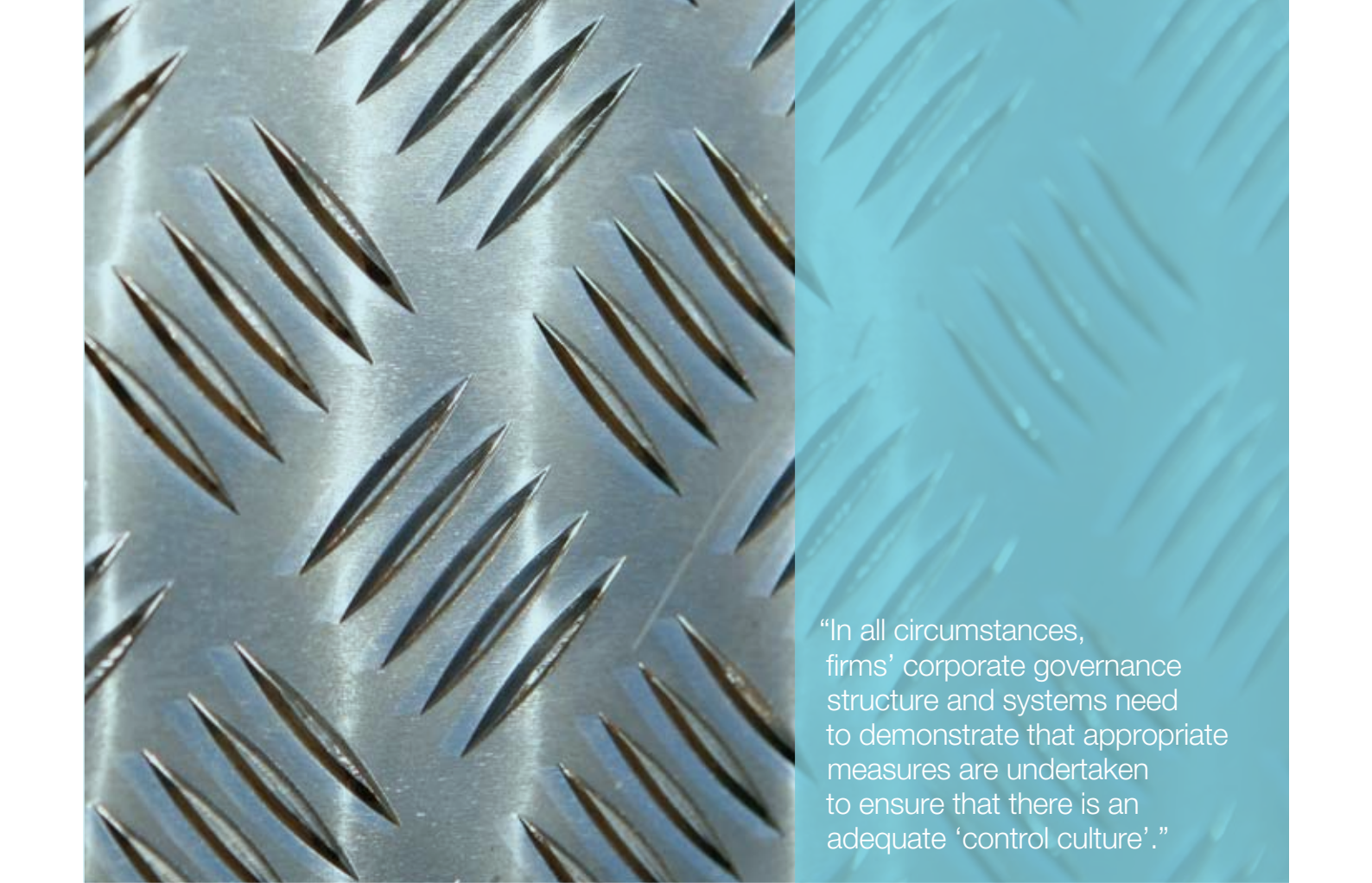
He remains “...unconvinced that all senior management have taken on board the need to change and operate in a genuinely different manner.” It is thus, “...essential for the regulator to facilitate further behavioural change in the firms and individuals we supervise.”

→ Ethical framework

The ‘new’ regime, insists Mr Sants, will ensure that ‘Individuals seeking to hold significant influence positions...are both technically equipped and demonstrate the required integrity’. Thus, from the embryonic stages of an authorisation application, to enforcement procedures against fully fledged firms and approved individuals, determinations will be made about “... an executive’s ability to set a strong ethical framework...”

→ Practical implications

This all draws together the tightening of controls around SYSC 4 (General Organisation Requirements), SYSC 5 (Employees, Agents and Other Relevant Persons), SYSC 6 (Compliance, Internal Audit and Financial Crime) and SYSC 7 (Risk Control). These requirements are core to “common platform” arrangements and firms subject to them are expected to demonstrate that their controls achieve an adequate level of compliance.



“In all circumstances, firms’ corporate governance structure and systems need to demonstrate that appropriate measures are undertaken to ensure that there is an adequate ‘control culture’.”

Continued...

As suggested, it is likely that the focus of the FSA is no longer simply the presence of documents that satisfy the requirements but more that those documents demonstrate active engagement in the process of preventing non-compliance in a constantly changing market place.

→ Motivation

This focus is not, presumably, intended to frustrate commercial activities, nor raise cost of compliance, but could be seen as a politically driven response to the widely held view that investment businesses were at fault in the financial crisis as well as the regulatory agencies. To counter this expediency, firms should exhibit appropriate care, particularly when expanding into new business risk areas.

→ Control culture & demonstrable engagement

In all circumstances, firms’ corporate governance structure and systems need to demonstrate that appropriate measures are undertaken to ensure that there is an adequate ‘control culture’ within the organisation and that senior management are actually involved in managing more than just investment performance related risks.

It is this demonstrable engagement that will be the standard required and, as the FSA’s judgement may be subjective it could be difficult to prove conclusively. It can only be achieved through building governance upon formal structures that reflexively record participation and consideration of the required risks by senior managers, partners and directors of every firm.

Nomura were recently fined £1.75 million, after a 30% discount, for SYSC failures. However, where such engagement is lacking, the FSA in future is likely to apply a control/culture deficiency tax on your firm in the form of increased regulatory capital requirements. In severe cases, the Mr Sants forewarns of more drastic steps. This may include removal of the part IV permission, or the refusal to grant one.

→ Next Steps

You should be considering this change in focus now and if you wish to discuss these notions in more detail please get in touch. MMS Regulatory Solutions can help you to assess any shortcomings there may be, help you to address these important regulatory challenges and ensure you remain abreast of developing best practice.

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