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# Implementation Issues Arising from the Revised UK Senior Manager and Certification Regime

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The UK Government recently announced that it would introduce a new statutory duty of responsibility on senior managers in all financial institutions and repeal the presumption of responsibility that would have applied to senior managers in banks and large investment firms. Senior managers will need to take reasonable steps to prevent a significant breach of a regulatory requirement in their area from occurring or continuing. The onus will be on the regulators to prove that the individual did not take reasonable steps. This note discusses the practical implications for firms and the individuals working in them of the senior managers regime as now proposed.

## Introduction

The Senior Manager and Certification Regime (“SM&CR”) will apply from 7 March 2016 to banks, building societies, credit unions and certain large investment firms<sup>1</sup> established in the UK, including UK subsidiaries of overseas firms (“SMR firms”). It will also apply to UK branches of third-country or European Economic Area (“EEA”) SMR firms (“incoming SMR branches”) in a modified format. The SM&CR does not apply to subsidiaries of SMR firms that are established outside of the UK. SMR firms and incoming SMR branches must act now to adapt their processes or implement new governance arrangements. There is a deadline of 8 February 2016 by which to notify the UK regulators of the identity of senior managers under the new regime.

The UK Government recently announced that it would implement certain changes to the SM&CR by amending the legislative provisions, originally published at the end of 2013, that introduced the framework of the SM&CR. Alongside those changes, the Government intends to extend the SM&CR to all UK authorised financial institutions from 2018. The proposed changes are set out in a Bill that

<sup>1</sup> Investment firms designated by the Prudential Regulation Authority (“PRA”).

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has been laid before Parliament. It remains to be seen whether all of the proposed amendments, particularly the removal of the reverse burden of proof, come about.

Details of the changes and the potential implications of the new regime are discussed below followed by a brief examination of the regimes that other jurisdictions have in place to ensure that individuals in financial institutions are accountable for misconduct.

## The “Reasonable Steps” of a Senior Manager

Senior managers will be those individuals who are responsible for managing one or more aspects of the firm’s regulated activities which pose a risk of serious consequences for the firm or for business or other interests in the UK. This includes taking decisions or participating in taking decisions about how any regulated activity should be carried on and covers board members, directors, heads of key business lines,<sup>2</sup> senior leaders and other decision-makers. Each of the responsibilities prescribed by the PRA and Financial Conduct Authority (“FCA”) must be allocated to an individual who will be carrying out a Senior Manager Function (“SMF”). A list of SMFs and prescribed responsibilities is set out in the Annex.

A statutory duty of responsibility will be introduced for all senior managers. They will be required to take reasonable steps to prevent regulatory breaches in the area of the firm for which they are responsible. The regulators will have the burden of proving, on the balance of probabilities,<sup>3</sup> that: (i) the senior manager’s firm committed a regulatory breach; (ii) the senior manager was a senior manager at the time of the regulatory breach; (iii) the senior manager was responsible for the management of any of the firm’s activities in relation to which the breach occurred; and (iv) the senior manager did not take such steps as a person in the senior manager’s position could reasonably be expected to take to avoid the contravention occurring (or continuing).

The extent of the duty of responsibility and its implications are uncertain at this stage. For example, it is not yet clear whether the regulators would need to establish a causative link between the senior manager’s failure to take reasonable steps and the breach before considering enforcement action. However, it is clear that, although the burden of proof would be on the regulators, senior managers will need to be in a

<sup>2</sup> A key business area is one with gross total assets greater than or equal to £10 billion; and which either account for more than 20% of the firm’s gross revenue or, if the firm is part of a group, is greater than 20% of the total gross revenue of the group.

<sup>3</sup> The Upper Tribunal confirmed this year in the case of *Carrimjee v the FCA* [2015] UKUT 0079 (TCC) that, despite the FCA having power to impose serious sanctions, such as industry bans or substantial fines, FCA proceedings are not quasi-criminal in character and the civil standard should always apply. Previous FCA jurisprudence suggested that a “sliding scale” standard of proof could be applied, whereby the civil standard could be varied to a standard close to its criminal equivalent in the event of serious regulatory breaches.

position to have identified and addressed actual or suspected regulatory breaches in a timely manner.

The guidance published by the regulators in the context of the previous presumption of responsibility test included actions that the regulators would consider being reasonable steps. It is hoped that further guidance from the regulators will be forthcoming, particularly if they wish to avoid firms requiring to focus attention on creating paper trails.

In the interim, senior managers may draw guidance from liability regimes under the Bribery Act 2010 and the Money Laundering Regulations 2007 (“MLR 2007”) which, to a certain extent, allow firms to discharge their obligations by implementing certain preventative systems and controls. Under section 7 of the Bribery Act 2010, a company may be liable for failing to prevent bribery by its “associated persons”<sup>4</sup> unless the company can show it had “adequate procedures” to prevent associated persons from engaging in such conduct. The UK Government’s guidance on what amounts to “adequate procedures” provides that companies will be expected to, for instance, implement and communicate to any employees and other associated persons clear anti-bribery policies and supplement this information with appropriate anti-bribery training.<sup>5</sup> Similarly, regulation 45(4) of the MLR 2007 provides that a firm will not be liable for breaches of certain obligations under MLR 2007 if it can show that it has taken “all reasonable steps and exercised all due diligence to avoid committing the offence.” Early guidance provided by the Financial Services Authority, later reiterated by the Joint Money Laundering Steering Group (“JMLSG”), suggested that the regulator would not expect firms to operate a “zero failure regime” and that firms would be likely to satisfy their obligations under the MLR 2007 by putting in place effective risk-based systems and controls that identify and mitigate money laundering risk.<sup>6</sup>

The reverse burden of proof for senior managers of SMR firms and incoming SMR branches will be repealed from the Financial Services and Markets Act 2000 (“FSMA”) prior to the SM&CR coming into effect. The presumption of responsibility for senior managers under wording originally contained in the Financial Services (Banking Reform) Act 2013 reversed the burden of proof by holding senior managers responsible for a firm’s regulatory breaches, unless they could prove that they took reasonable steps to prevent the breach from occurring or continuing. HM Treasury has stated that amendments will be made to the legislation to ensure that the presumption of responsibility does not come into effect on 7 March 2016.<sup>7</sup>

### **Statutory Obligation to Report All Breaches of Rules of Conduct to the Regulators**

Under the SM&CR, new Conduct Rules will apply to all senior managers, certified employees<sup>8</sup> and other employees as specified by the FCA. The PRA will require firms to bind senior managers contractually to comply with the Conduct Rules. The definition of employee includes sub-contractors, employees of sub-contractors and employees of a

<sup>4</sup> Section 8 of Bribery Act 2010 defines “associated persons” broadly as any persons who perform services for or on behalf of the company, including its employees, agents or subsidiaries.

<sup>5</sup> The UK Government’s guidance on what constitutes “adequate procedures” is available [here](#).

<sup>6</sup> See the FSA letter to the chairman of JMLSG, available [here](#), and the JMLSG Guidance (November 2014), Part I, paragraph 4.4, available [here](#).

<sup>7</sup> By an amendment to the Financial Services (Banking Reform) Act 2013 (Commencement No. 9) Order 2015.

<sup>8</sup> Examples of employees who will be certified include staff responsible for benchmark submission and administration, proprietary traders and material risk takers (in line with the UK Remuneration Code).

company in the same group responsible for employing staff for the group. The current statutory requirement<sup>9</sup> that SMR firms and incoming SMR branches report all breaches of the Conduct Rules to the regulators is to be removed. Again, HM Treasury has provided assurance that the obligation will not come into effect on 7 March 2016.<sup>10</sup> Instead, the PRA and FCA will be charged with adopting rules to ensure that they are notified of breaches on a proportionate basis. It remains to be seen whether the regulators will maintain rules requiring a breach by a senior manager to be notified within seven days of the firm's knowledge of the breach or suspected breach or other notification requirements for relevant employees. SMR firms and incoming SMR branches will still need to notify relevant individuals that the Conduct Rules apply to them and take steps to ensure that those individuals understand how the rules work, including by providing training. Some terms of employment may need to be reconsidered. Firms will also still need to notify the regulators when they take disciplinary action against a senior manager or employee for breach of the Conduct Rules.

### Applying the Rules of Conduct to Non-Executive Directors

Only non-executive directors ("NEDs") with committee responsibilities will be designated as senior managers, namely the Chairman of the Board and chairs of the Remuneration, Risk, Audit and Nominations Committees. This approach means that only in-scope NEDs would be subject to enforcement action by the regulators for breach of the Conduct Rules. To ensure compliance with certain EU legislation that action can be taken against all members of a firm's management body, the FSMA will be amended to allow the regulators to take action against any director of an authorised firm. However, for many NEDs this would not be under the SM&CR.

### Extension of the SM&CR

The Fair and Effective Markets Review ("FEMR")<sup>11</sup> separately recommended that certain elements of the SM&CR be extended to a broader range of regulated fixed income, currency and commodity ("FICC") market participants, covering at least those active in the FICC wholesale markets - such as investment firms subject to the Markets in Financial Instruments Directive,<sup>12</sup> managers of alternative investment funds and units in collective investment trusts and possibly others. The FEMR also proposed that any extension should exclude the presumption of responsibility and the potential for criminal liability of senior managers for a reckless decision that causes a firm to fail. The UK Government is preparing to adopt these recommendations, although the scope of affected firms goes beyond what was initially contemplated by the FEMR. It is proposed that the SM&CR will apply to all sectors of the financial services industry, including insurers,<sup>13</sup> investment firms (i.e., stock brokers, securities and futures firms, asset managers and financial advisers) and consumer credit firms. The rationale for this is that the extension of the SM&CR will remove opportunities for regulatory arbitrage, support competition and bring about an efficient regulatory system for all types of financial services firms.<sup>14</sup>

<sup>9</sup> See FSMA, section 64B.

<sup>10</sup> By an amendment to the Financial Services (Banking Reform) Act 2013 (Commencement No. 9) Order 2015.

<sup>11</sup> The final report of the FEMR is available [here](#).

<sup>12</sup> MiFID I is in effect until 3 January 2017 when it will be replaced by the new Markets in Financial Instruments Directive and Markets in Financial Instruments Regulation, together known as MiFID II.

<sup>13</sup> The PRA has introduced a Senior Insurance Managers Regime for insurance firms subject to the EU Solvency II Directive. It appears that that regime will now be amended to incorporate the amended SM&CR.

<sup>14</sup> See HM Treasury policy paper on the extension of the Senior Manager and Certification Regime to all FSMA authorised firms, available [here](#). The legislative changes required are mostly set out within the Bank of England and Financial Services Bill (HL Bill 65).

It is proposed that the extended regime would become operational in 2018. As things stand, the existing Approved Persons Regime (“APR”) will continue to apply to all UK regulated firms that are not SMR firms or incoming SMR branches until the changes are made and implemented. For certain firms, that means that they will need to comply with both the SM&CR as well as the APR. A degree of overlap between the regimes may result. A list of APR functions is set out in the Annex.

## US Perspective

While no statutory duty of responsibility exists for senior managers in the US, US regulators have also been increasingly focused on individual accountability and oversight of personnel who can expose an institution to significant risk as well as on ensuring that firms have the proper internal controls to monitor and manage such risk. More prescriptive regulatory requirements and responsibilities for the board of directors and other executive management, particularly the heads of the risk, compliance, audit and legal functions have been implemented as a result. For example, the Office of the Comptroller of the Currency’s so-called “heightened standards” for certain large institutions require boards of directors actively to oversee a bank’s risk-taking activities and that the board or a board committee approve a formal risk governance framework and appoint or approve a chief audit executive and chief risk executive.<sup>15</sup> The Federal Reserve Board’s “enhanced prudential standards” for certain large banking organizations include an increased focus on risk management as well, requiring a chief risk officer and requiring the board of directors to include at least one independent director and one risk management expert. Additionally, the Volcker Rule requires an annual attestation by a CEO or a senior management officer in charge of the US operations of a foreign bank to attest that it has a compliance program in place reasonably designed to achieve compliance with the Rule.<sup>16</sup>

US banking regulators can, like their EU counterparts, dismiss employees as part of any enforcement action against firms and can take enforcement actions against directors and officers (and other so-called “institution-affiliated parties”) for violations of laws, breaches of fiduciary duties and unsafe and unsound practices. For example, the Federal Reserve Board can remove any officer, director, employee or institution-affiliated party of an insured depository institution under its supervision upon a finding that, among other actions, he or she has engaged in unsafe or unsound practices in connection with an insured depository institution, breached his or her fiduciary duties or has been convicted of certain criminal offenses.<sup>17</sup> The business judgment rule presumption in the US generally affords directors and officers protection from personal liability for prudent, informed business decisions made in good faith, but if any of the aforementioned acts involved personal dishonesty or demonstrated a wilful disregard for the safety and soundness of the institution, the Federal Reserve Board can order their removal.<sup>18</sup>

There have also been some suggestions about further steps such as extending the Federal Deposit Insurance Act prohibition against the employment of a person convicted of a crime of dishonesty, breach of trust or money

<sup>15</sup> Office of the Comptroller of the Currency, Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations, 79 Fed. Reg. 54518 (11 September 2014). See also, Board of Governors of the Federal Reserve System, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17240 (27 March 2014), requiring the board of directors to approve the company’s liquidity risk tolerance and evaluate the company’s liquidity risk management.

<sup>16</sup> Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Securities and Exchange Commission, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (31 January 2014).

<sup>17</sup> 12 U.S.C.A. § 1818(e).

<sup>18</sup> *Id.*

laundering by an insured depository institution or bank holding company to cover the entire financial services industry. The creation of a database, akin to that which currently exists for US broker-dealers, to track the hiring and firing of financial professionals and which would be maintained by financial institution supervisors has also been raised as a possibility.<sup>19</sup>

## German Comparison

Under the German Stock Corporation Act, board members of stock corporations are jointly and severally liable for breaches of their directors' duties unless they can demonstrate they acted with due care and skill. Where the allegations relate to the directors' business decisions, the board members may benefit from the operation of the "business judgment rule", which provides a degree of protection for decisions made on the basis of adequate information and for the benefit of the company. However, directors bear the burden of proof to show satisfaction of the requirements of the business judgment rule.

The reverse burden of proof and the scope of the business judgment rule, in particular with regard to compliance-related decisions taken by board members of regulated entities, are currently under scrutiny and it remains to be seen whether the German legislature or courts will take action to mitigate the liability risk for board members.

## Conclusion

The introduction by the UK Government of a new liability regime for financial institutions is intended to make "individual responsibility in banking a reality."<sup>20</sup> The issues that have arisen during implementation of the SM&CR are testament to how difficult it is to achieve a balance between ensuring that the regulators are able to bring those responsible for significant failures in firms to account and ensuring that the regime operates fairly. The recent testimony of Andrew Bailey, Chief Executive Officer of the PRA, before the Treasury Committee<sup>21</sup> refers to the role played by lawyers in highlighting that the reverse burden of proof would introduce risks of legal enforceability and raise legal questions around human rights. His testimony also refers to the substance of the SM&CR as holding individuals accountable for the area for which they are responsible. He explains that the introduction of the SM&CR is a "shift from [the regulators] having to prove [a senior manager] did something or they deliberately did not do something to responsibility in their stated area, and [the regulators] are not relying on finding individual actions."

<sup>19</sup> "Enhancing Financial Stability by Improving Culture in the Financial Services Industry," William C. Dudley, President and Chief Executive, Remarks as the Workshop on Reforming Culture and Behavior in the Financial Services Industry, Federal Reserve Bank of New York, New York City (October 20, 2014), available [here](#).

<sup>20</sup> Parliamentary Commission on Banking Standards, Final Report: Changing banking for good (June 2013).

<sup>21</sup> The transcript of the testimony is available [here](#).



## Summary of the Proposed Revised SM&CR.

### Senior Manager Regime

- Assigning key responsibilities to specific individuals: prescribed responsibilities allocated to individuals performing senior management functions, preparation and submission of a responsibilities map and Statements of Responsibility.
- Statutory duty of responsibility – senior managers need to take reasonable steps to stop or prevent contraventions.
- Regulatory approval and criminal checks for all senior managers.
- Personal liability: potential criminal prosecution for a reckless decision that causes a firm to fail. Only applies to senior managers working in UK SMR firms (and not UK branches of overseas firms) that are deposit-taking institutions.
- Firm to vet senior manager candidates first; regulators to approve.

### Certification Regime

- Internal approval framework for individuals who are not senior managers but may cause serious harm to the firm, its reputation, or its customers (i.e., the certified employees): no approval by regulators.
- Assessment of fitness and propriety at time of appointment and on an ongoing basis.
- Criminal records checks are not required.

### Code of Conduct

- Will include a wider group of employees than is currently the case under the APR and includes all employees except those engaged in ancillary activities and all financial services activities (both regulated and unregulated activities).
- Any notifications of transgressions to the regulators will now be decided by regulators.
- Firms expected to take corrective action themselves but the regulators will be able to take enforcement action if necessary.

### Timeline

July 2015	1 January 2016	8 February 2016	7 March 2016	7 September 2016	7 March 2017	2018
Remuneration rules come into effect for Senior Managers.	Forms for new Senior Manager Function available.	Deadline for firms to notify PRA & FCA of their senior managers.	Implementation date of the SM&CR and Conduct Rules (for those currently within the scope of SM&CR).	Implementation date for the whistleblowing rules.	Firms to have issued certificates for existing staff under Certification Regime.	Extension of SM&CR to all UK authorised firms.
Draft order on application of SM&CR to UK branches of foreign firms laid before Parliament.	<b>Outstanding Final Rules</b> <ul style="list-style-type: none"> <li>• UK branches of foreign banks (near final rules published August 2015)</li> <li>• Regulatory references (currently open to consultation until 7 December 2015)</li> </ul>				Conduct Rules will apply to those staff outside of SM&CR from 7 March 2017.	

## Annex: Prescribed Responsibilities

PRA	FCA
<b>All Firms</b>	
Firm's performance of its obligations under the SMR	
Firm's performance of its obligations under the Certification Regime	
Compliance with the firm's obligations for its management responsibilities map	
Allocation of all prescribed responsibilities	Firm's policies and procedures for countering risk of financial crime
<b>Large Firms</b>	
Monitoring effective implementation of policies and procedures for the induction, training and professional development of senior management, other than members of the governing body	
Overseeing the adoption of the firm's culture in the day-to-day management of the firm	
Managing the allocation and maintenance of the firm's capital, funding and liquidity	
Firm's treasury management functions	
Production and integrity of the firm's financial information and its regulatory reporting under the regulatory system	
Developing and maintaining the firm's recovery plan and resolution pack and for overseeing the internal processes regarding its governance	
Managing the firm's internal stress tests and ensuring the accuracy and timeliness of information provided to the PRA and other regulatory bodies for the purposes of stress testing	
Development and maintenance of the firm's business model by the governing body	
Leading the development of the firm's culture by the governing body	
Firm's performance of its obligations under Fitness and Propriety for NEDs	
Independence, autonomy and effectiveness of the firm's policies and procedures on whistleblowing	
<b>Large Firms - NEDS</b>	
Leading the development and monitoring effective implementation of policies and procedures for the induction, training and professional development of all members of the firm's governing body	
Safeguarding the independence of, and overseeing the performance of, the internal audit function, including the performance of a person approved to perform the Head of Internal Audit function	
Safeguarding the independence of, and overseeing the performance of, the compliance function, including the performance of a person approved by the FCA to perform the compliance oversight function	
Safeguarding the independence of, and overseeing of the performance of, the risk function, including the performance of a person approved to perform the Chief Risk function	
Developing and overseeing the firm's remuneration policies and practices	
<b>Specific Types of Firms</b>	
Proprietary trading firms - responsibility for the firm's proprietary trading activities	Compliance with CASS
If the firm does not have a person who performs the Chief Risk function, responsibility for the compliance of the firm's risk management systems, policies and procedures	
If the firm outsources its internal audit function, responsibility for taking reasonable steps to ensure that every person involved in the performance of that function is independent from the persons who perform external audit, including: (a) supervision and management of the work of outsourced internal auditors; and (b) management of potential conflicts of interest between the provision of external audit and internal audit services	
Ring-fenced bodies - responsibility for ensuring that those aspects of the firm's affairs for which a person is responsible for managing are in compliance with the ring-fencing requirements	
<b>Small Firms (assets of £250mn or less)</b>	
Implementation and management of the firm's risk management policies and procedures	
Managing the systems and controls of the firm	
Managing the firm's financial resources	
Ensuring the governing body is informed of its legal and regulatory obligations	



## Annex: Senior Manager Functions and Controlled Functions

### Who are “Senior Managers?”

- |  |  |
|--|--|
| <ul style="list-style-type: none"> <li>▪ PRA Functions                             <ul style="list-style-type: none"> <li>▪ SMF1 Chief Executive</li> <li>▪ SMF2 Chief Finance</li> <li>▪ SMF4 Chief Risk</li> <li>▪ SMF5 Head of Internal Audit</li> <li>▪ SMF6 Head of Key Business Area</li> <li>▪ SMF7 Group Entity Senior Manager</li> <li>▪ SMF9 Chairman</li> <li>▪ SMF10 Chair of Risk Committee</li> <li>▪ SMF11 Chair of Audit Committee</li> <li>▪ SMF12 Chair of Remuneration Committee</li> <li>▪ SMF14 Senior Independent Director</li> <li>▪ SMF8 Credit Union for small Credit Unions</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>▪ FCA Functions                             <ul style="list-style-type: none"> <li>▪ SMF3 Executive Director</li> <li>▪ SMF13 Chair of Nominations Committee</li> <li>▪ SMF16 Compliance Oversight</li> <li>▪ SMF17 Money laundering reporting</li> <li>▪ SMF18 Overall Responsibility</li> </ul> </li> </ul> |
|--|--|
- \*Notes:
1. NED functions in blue text
  2. There is no function numbered SMF15

### Approved Persons

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>▪ PRA Functions                             <ul style="list-style-type: none"> <li>▪ CF1 Director Function</li> <li>▪ CF2 Non-executive director function</li> <li>▪ CF3 Chief executive function</li> <li>▪ CF4 Partner function</li> <li>▪ CF5 Directors of an unincorporated association function</li> <li>▪ CF6 Small friendly society function</li> <li>▪ CF12 Actuarial function</li> <li>▪ CF12A With-profits actuary function</li> <li>▪ CF12B Lloyd’s actuary function</li> <li>▪ CF28 Systems and controls function</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>▪ FCA Functions                             <ul style="list-style-type: none"> <li>▪ CF8 Apportionment and oversight function (non-MiFID business only)</li> <li>▪ CF10 Compliance oversight function</li> <li>▪ CF10A CASS Oversight Operation function</li> <li>▪ CF11 Money laundering reporting function</li> <li>▪ CF29 Significant management function</li> <li>▪ CF30 Customer function</li> <li>▪ CF40 Benchmark submission function</li> <li>▪ CF50 Benchmark administration function</li> </ul> </li> </ul> |
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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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