

COMPLIANCE IRELAND BRIEFING NOTE – APRIL 2011

CP51 on the Fit and Proper Regime

Background

The disqualification in April 2011 of Jim Lacey from acting as a company director came six years after proceedings were launched by the ODCE and thirteen years after allegations were aired by RTE. Such extensive delay between commencement of enforcement and delivery of outcome gives rise to public cynicism about the willingness or capacity of authorities to act against transgressors. Such delays also signal to the regulated themselves that compliance with regulation has an optional quality. Both of these outcomes are undesirable from a public policy perspective and are potentially damaging to efforts to rebuild the international reputation of the Irish financial services sector.

The Central Bank has put considerable effort into countering such corrosive attitudes. December 2010 saw the publication of the Enforcement Strategy 2011-2012 policy document. This provides the framework for the '*credible threat of enforcement*' so necessary if regulatory obligations are to be properly respected. The Central Bank is now moving on to the next areas requiring attention and has identified two critical systemic weaknesses in Irish financial services businesses:

1. Weak or absent corporate governance.
2. Weak or deficient individual behaviour at board and senior management level:
 - Persons who were complacent.
 - Persons who lacked the knowledge and expertise to challenge their peers.
 - Persons who simply did not understand the risks of their own business.

The recent Corporate Governance Code of Conduct for banks and insurers (and forthcoming companion codes for other sectors) is designed to address the first issue.

The revised Fit and Proper Regime set out in CP51 is designed to comprehensively address the second. Submissions are invited up to 20 May 2011. It is the Central Bank's intention that the finalised rules will come into force with effect from 1 September 2011.

Purpose

The Fit and Proper regime was originally introduced in November 2006, but the Central Bank is proposing much more than a simple revision to this existing regime. CP51 sets out proposed operating details for the Control Function provisions set out in the Central Bank Reform Act 2010.

- Control Functions (“CFs”) and Pre-approval Control Functions (“PCFs”) will be defined.
- Persons in CFs and PCFs will be subject to the Fit and Proper Regime.
- Firms will have to assemble and maintain lists of persons in CFs and PCFs.
- Firms will have to display due diligence to prove Fit and Proper compliance by persons in CFs and PCFs. This will include ongoing monitoring of persons in CFs and PCFs as well as disciplining and/or removing persons no longer Fit and Proper compliant.
- On commencement, the boards of firms will have to certify to the Central Bank that they are satisfied that persons in CFs and PCFs are compliant. One can imagine that directors faced with such a certification demand will require proper evidence from management that appropriate processes are in place.

There are two legs to this exercise. Firstly, the definitions of CFs and PCFs will be set out in a statutory instrument. These are typically issued by a minister; however certain other agencies have also been delegated power to issue statutory instruments, typically for limited purposes such as the setting of fees. The Central Bank Reform Act 2010 gave the Central Bank the power to *“make regulations prescribing functions that are to be controlled functions”*, which the Central bank now proposes to exercise.

Secondly, the Central Bank proposes to issue a Code on Fitness and Probity under a specific power in Section 50 of the Central Bank Reform Act 2010. This power is not limited in its application and so can apply across all sectors of regulated businesses, avoiding the inconsistencies that would inevitably occur if introduced using sector by sector legislation.

The Code redefines what it means to be fit and proper:

- Competent and capable.
- Honest, ethical and to act with integrity.
- Financially sound.

Competent and Capable

Relevant to the function being performed, a person must comply with each of the following:

1. Have an appropriate professional or other qualification and capability.
2. Have obtained appropriate competence and skills, through training or prior experience.
3. Have demonstrated competence and proficiency.
 - There is a caveat attached to this requirement that where the person was performing at an institution that required state support, consideration will be given as to whether the actions of the person under scrutiny contributed to the need for state support and this would reflect (adversely) on any determination as to competence and capability. The intention to subject legacy board members of state-supported banks to review in this light in 2012 has been heavily trailed by Matthew Elderfield in recent speeches.

4. Have a sound knowledge of the business and the specific responsibilities of the role.
5. Have a clear and comprehensive understanding of the regulatory and legal environment appropriate to the function.
 - This is an interesting addition to the requirements – ignorance of the law is definitely no longer an excuse!
6. Be mentally and physically capable of performing the role.
 - This is presumably to permit the removal of persons claiming temporary incapacity in situations of stress, or where there are suspicions of incapacity.
7. Not allow other responsibilities to impair their carrying out the role.
8. Be compliant with applicable Minimum Competency Requirements.

Honest, Ethical and Acting with Integrity

These requirements are closest in nature to the existing probity requirements, as they concern themselves with whether persons have disqualifications, convictions or similar sanctions against them. The requirements include situations where persons were dismissed or asked to resign and may bring to the surface admissions regarding former employment terminations when enacted.

Financial Soundness

This requirement requires a person in a CF or PCF to manage their affairs in a sound and prudent manner. This section of Fit and Proper gives grounds for removal where a person does not fulfil their financial obligations or is the subject of an unsatisfied judgement. While this might appear obvious, the situation recently arose where the managers of a bank were loaned significant amounts of money to invest in shares in the bank. The shares collapsed, but the loan obligations remained. If the individuals defaulted on these loans, would they really be fit and proper persons to be in positions of responsibility of a financial institution?

Control Functions

CFs are described in broad terms in the Central Bank Reform Act 2010. CP51 does not propose a broadening of the scope. Indeed, advice is sought as to how the definitions could be usefully narrowed. In particular, anyone involved in *“the giving of advice or assistance to a customer”* is defined as carrying out a CF. The Central Bank does not think it useful to include under this heading, for example, all of the staff at a customer care call centre, although it would like to retain CF status for the managers of such staff. Suggestions in this area are specifically invited by the Central Bank.

CFs remain CFs where carried out by third parties, even if those third parties are otherwise unregulated. This is likely to provide issues for firms which have extensively relied on outsourcers or even group-level facilities to ensure they can demonstrate ongoing Fit and Proper compliance outside of their own regulated entity.

Pre-approval Control Functions

The Central Bank has come up with a list of PCFs, the occupants of which can exercise a significant influence on the firm's affairs. These functions are listed in Schedule 2 of the proposed statutory instrument. There is very close attention paid to board function and several board committee roles are separately designated (e.g. Chair of the Risk Committee, Chair of the Audit Committee).

In addition, management heads of function are designated as PCFs. Again, special attention is directed at control and feedback functions such as Head of Compliance and Head of Internal Audit. Part 2 of Schedule 2 considers individual sectors and nominates industry-specific PCFs such as Head of ALM for banks, Head of Transfer Agency for funds administrators and so on.

As the name suggests, prior approval of the Central Bank is required in writing before a PCF position can be offered to a successful candidate.

Conclusions

Again, the Central Bank has produced a very clear and well thought out document. It will have a major impact on boards of directors, requiring them to demonstrate and document compliance with the Fit and Proper criteria. Management also will be required to design and implement procedures to identify all persons in CFs and PCFs in their organisations, to monitor and prove ongoing compliance with Fit and Proper criteria and to clearly act against transgressors. But when you think about it – shouldn't it always have been this way?

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Please contact us at email@complianceireland.com or + 353 1 425 5962 should you wish to discuss any of the matters above.