The final rules: regulatory references in banking and insurance

From 7 March 2017, firms in the banking and insurance sectors will be subject to new rules on regulatory references.

The new rules are intended to help prevent the "recycling" of individuals with poor conduct records, so-called "rolling bad apples", between firms.

The new rules form part of the Senior Managers and Certification Regime (**SMCR**) for banks, building societies and other financial institutions and the Senior Insurance Managers Regime (**SIMR**) for insurance firms.

Following an extended period of consultation, the regulators have now published the final rules.

Current position: interim rules based on old approved persons regime

Under the old Financial Conduct Authority (**FCA**) approved persons regime (in force before 7 March 2016):

- the rules on regulatory references related to "approved persons" only;
- there was no obligation to seek a reference;
- firms were obliged to provide a regulatory reference if asked to do so; and
- in particular, firms were obliged to give, as soon as reasonably practicable, all relevant information of which they were aware.

Since 7 March 2016, interim FCA rules on references have applied for all regulated firms. In broad terms, these rules are a continuation of the old regime and only relate to individuals subject to regulatory pre-approval.

However, in addition, the Prudential Regulation Authority (**PRA**) has introduced new interim rules for PRA regulated firms, including:

- a new obligation to provide regulatory references for a wider group (e.g. including PRA certified persons as well as senior managers); and
- a new obligation to take reasonable steps to obtain appropriate references covering at least the last 5 years' service (e.g. from current and former employers).

Final rules: coming into force on 7 March 2017

The final rules include fundamental changes which carry far reaching implications for HR practice in the banking and insurance sectors. In summary, the final rules:

- confirm the extension of the reference regime to a **much wider group** of individuals;
- introduce new obligations on firms to **request references going back 6 years**;
- require firms to **disclose all relevant information** for the reference period (unless there is serious misconduct when there is no time limit);
- introduce a **mandatory reference template**;
- require firms to **update references for 6 years** following termination of employment.

Who is caught?

The obligation to request references covers candidates for Senior Management Functions, Senior Insurance Management Functions, Controlled Functions and Certification Functions.

The obligation to give references under the new regime covers both these candidates and candidates for Key Function and Notified Non-Executive Director roles.

Whether firms are requesting or giving a reference, the new regime covers a much wider group of individuals (in particular certified persons) beyond the relatively small group of individuals who require regulatory pre-approval. By itself, this poses a significant logistical and cultural challenge for firms, which are used to regulatory references for a small group of senior staff only and, for everyone else, either short form basic references or negotiated references.

Reasonable steps to obtain appropriate references

Where a firm is appointing someone to a relevant role (see above), it must take reasonable steps to obtain appropriate references from the individual's current employer and anyone else who has employed them in the past 6 years.

Where an appointment is subject to pre-approval by the regulator, as it is for senior managers, the FCA would normally expect the firm to have obtained the reference before the application for approval is made. In the case of certified person appointments, the firm must take reasonable steps to obtain the reference before the certificate is issued.

Obligation to give references

If requested, in relation to a relevant role (see above), firms must give a reference as soon as reasonably practicable and the FCA expects that firms should normally be able to do so within 6 weeks.

Firms are required to use a mandatory template and include information about (amongst other matters):

- any conclusion that the individual was not fit and proper to perform a function (and details of any associated disciplinary action);
- any disciplinary action for a breach of the conduct rules;
- any disciplinary action which relates to the individual not being fit and proper; and
- any other information which the firm giving the reference reasonably considers to be relevant to the assessment of whether the individual is fit and proper.

Firms are required to disclose matters that happened or existed either:

- in the 6 years before the reference was requested; or
- between the date of the reference request and the date on which the reference is given.

However, the 6 year time limit does not apply to "serious misconduct" which must be disclosed regardless of when it happened.

In determining what is serious misconduct, the key question is how important the information still is for the recruiting firm's assessment of the function that the candidate would perform.

The FCA guidance gives examples of matters to take into account when deciding whether old misconduct is sufficiently serious to disclose. For example, the FCA guidance states that dishonesty is an important factor but it is not automatically decisive in every case.

Another relevant factor is whether the firm giving the reference would recruit the individual today notwithstanding the time that has passed. It follows that deciding what is "serious misconduct" will not necessarily be straightforward and achieving consistency will be challenging.

For these purposes, "disciplinary action" means the issue of a formal warning or disciplinary suspension (but not suspension pending the conclusion of a disciplinary investigation) or dismissal or the reduction or recovery of remuneration. The requirement to disclose such sensitive matters across such a long time period will inevitably lead to increased tension across a range of areas including fit and proper assessments, disciplinary action and performance adjustment to remuneration.

Updating references

Where a firm has given a reference and subsequently becomes aware of information that would have required it to write the reference differently, then in certain circumstances, it must:

(a) make reasonable enquiries as to the identity of the individual's current employer; and

(b) provide an updated reference to the current employer as soon as reasonably practicable.

Where individuals, such as certified persons, are not listed on the FCA's list of regulated persons, it is not clear what will constitute "reasonable enquiries" for these purposes (beyond asking the recipient of the original reference and viewing LinkedIn or similar sites). The obligation to update will apply for the remainder of employment and the 6 years following termination of employment.

The PRA's view is that, in practice, updating is likely to be limited to circumstances where misconduct comes to light after an employee has left the firm and that firm is able to conclude that the misconduct and a breach of the conduct rules by the former employee occurred.

Leaving while under investigation

Firms will need to carefully consider what to include in a reference where an employee leaves employment while under investigation, for example for a breach of the conduct rules or for a failure to meet fit and proper requirements.

The FCA guidance states that a firm should, wherever feasible, conclude investigative procedures before the employee departs. However, the FCA rules do not require a firm to disclose information that has not been properly verified.

According to the FCA guidance, the rules do not necessarily require firms to state that a former employee left while disciplinary proceedings were pending or on-going.

The FCA guidance points out that including such information is likely to imply cause for concern even though the firm may not have established misconduct.

On the other hand, the FCA guidance states that a firm may include such information in a reference if it wishes to and, further, that a firm should give as complete a picture of an employee's conduct record as possible.

Ultimately, notwithstanding the guidance, it's important to remember the key rules themselves. When deciding what to say a firm will need to decide whether, even though the employee has left before a disciplinary hearing could take place, it has either reached a conclusion on fitness and propriety (based on properly verified information) or otherwise has (properly verified) information relevant to fitness and propriety, such that disclosure is necessary.

At the same time, firms should consider the wider risks beyond the regulatory regime (see below).

Fairness: right to comment?

The FCA guidance recognises that a firm will also need to have regard to its duty, owed to the employee and the recipient firm, to exercise due skill and care in the preparation of the reference. Accordingly, the FCA guidance is that references should be true, accurate, fair and based on documented fact.

The FCA suggests that, for the purposes of the "general duty" under the law, fairness will normally require a firm to have given the individual an opportunity to comment on information to be included in a reference.

However, the guidance states that this does not mean the firm should provide an opportunity to comment on the reference itself, as opposed to the allegations on which it is based. The guidance envisages that firms may give employees an opportunity to comment sometime before the reference is prepared.

In practice, this might be when a conduct notification is made, when disciplinary action is taken or when the firm updates the regulator about a fit and proper assessment.

The guidance also envisages that fairness may require firms to give an opportunity to comment on the updating of references (e.g. several years after the end of employment). Giving former employees an opportunity to comment will raise difficult questions (e.g. about what information should be shared).

Firms will need to consider how best to deal with all of these points in their policies and procedures.

Competing risks

The FCA guidance recognises some of the competing risks arising from compliance with the reference rules. In particular, giving current employees an opportunity to comment on allegations may help to manage the risk of constructive dismissal claims.

In practice, giving an opportunity to comment will also help firms manage the risk of claims for negligent misstatement from current and former employees.

Also, where employees leave whilst under investigation, there is a Court of Appeal decision that offers some comfort to firms: the Court has held that an employer was entitled to provide a reference which referred to unsubstantiated allegations against an employee because it made clear in the reference that those allegations had not been investigated.

However, compliance with the rules will carry wider employee relations risk too. There is a fundamental tension between the reference rules (and the underlying intention to stop "rolling bad apples") and the risk of employment claims arising from what is disclosed or omitted from a reference.

Firms could be vulnerable to claims for discrimination / victimisation or whistleblowing detriment, particularly where whistleblowing concerns or discrimination complaints have already been raised by the employee.

In practice, firms will be very mindful that disclosures in a reference can be career limiting and that employees are less likely to bring claims if they find another job. The challenge will be to balance these considerations against regulatory obligations.

No limits on disclosure

In keeping with the old regime, firms must not fetter their ability to disclose information by agreeing limits with the employee and, regardless, the reference rules will apply notwithstanding any such agreement or arrangement.

Group companies

Where an employee of one group company moves to another group company (or simply carries out a relevant role for another group company), then there is no obligation to request a reference if there are adequate arrangements in place under which the group companies have access to the same information sources (i.e. centralised records or alternative measures).

Joined up approach to training, resourcing, policies and procedures and record keeping

The final rules will be one of the more challenging aspects of the SMCR and SIMR for firms to deal with. The FCA rules reinforce the practical challenges ahead by requiring firms to establish policies and procedures, and orderly record keeping, to support compliance. Of equal importance is the need to ensure a joined up approach between HR and compliance teams and to properly train staff about the competing risks.

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