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Second Chances? What the Neil Woodford Matter Tells Us about the FCA Fit & Proper Test

Jeffrey M Bronheim; Ash Gulati; Tim Harris; James R Mossetto; Patrick Ferguson

Introduction

- On 14 February 2021, Neil Woodford (a high-profile investment manager in the UK) announced his intention to launch a new fund management firm operated out of the UK and Jersey. Woodford's announcement was highly controversial given that retail investors suffered substantial losses following the 2019 collapse of his LF Woodford Equity Income Fund (the "Fund"). The UK Financial Conduct Authority (the "FCA") is still considering enforcement action against Woodford and others for misconduct in the collapse – the main issue seems to have been excessive illiquid positions which forced the gating of the Fund in the face of escalating redemption requests.

- Woodford's announcement of his new firm prompted a robust (and unusual) public response from the FCA. The FCA's Director of Enforcement and Market Oversight, Mark Steward, confirmed in a press release that it was closely following developments and that the FCA and the Jersey Financial Services Commission (the "JFSC") would share information relating to any application made by Woodford to set up in either jurisdiction. He also confirmed that the ongoing FCA investigation into the Fund's collapse was complex, ongoing and not yet at the stage to conclude whether there had been misconduct.

- The collapse of the Fund and Woodford's demise was truly shocking in the UK. As one of the industry's highest profile managers, it shook the funds industry to its core. He remains an approved person, albeit one subject to a complex investigation which could lead to enforcement action, which if successful would be bound to include a finding of unfitness to perform at least some controlled functions. However, the affair prompts the question as to whether an individual with recent regulatory history can resume a role in the financial services industry and, if so, what is the process?

How does the FCA Fit & Proper test (the "FIT Test") operate?

The FIT Test[1] is applied by the FCA as it considers: a) the authorisation of a firm or individual, but also b) whether enforcement action against an individual (such as may be taken against Woodford) is required. When considering the fitness and propriety of a person to perform a controlled function, the FCA will take into account a number of factors (detailed in its FIT Chapter 2 main assessment criteria), including the person's: 1) honesty, integrity and reputation; 2) competence and capability; and 3) financial

[1] *For the FIT Test (see here)*

soundness. The FCA will also have regard to the activities of the firm in relation to which the controlled function will be performed, the permissions held by the firm, and the markets within which it operates.

While applications are treated on a case-by-case basis and the FCA states that they will have regard to all relevant matters, the criteria set out in the FIT Test will inform the FCA's decision. For instance, in relation to a person's honesty, integrity and reputation, the FCA will consider all relevant matters which may have arisen in the UK or elsewhere, including those listed in FIT 2.1.3 G. This effectively allows the FCA to take into account any situation in which an individual's conduct has been negatively assessed as relevant to their regulated activities. The FCA's approach to applying the FIT test (as with all their enforcement powers) can best be ascertained by reference to the notices published on its website.

The more serious and credible the allegation, the more adversely it may impact an individual's application. For instance, in his recent judgment in *PCP Capital Partners LLP v Barclays Bank Plc*, Waksman J issued a number of adverse findings about senior managers of Barclays, even though Barclays was not found to be culpable. These findings would be seen by the FCA and expected to have implications for the criticized individuals were they to seek individual approvals in the future, or were firms for which they work to seek to change their permissions.

Senior Managers and Certification Regime

Importantly, the FIT Test is applicable not only to the FCA decision process but also to firms who must consider the FIT Test when self-certifying the fitness and propriety of existing staff. This process is part of the relatively recent Senior Managers & Certification Regime (the "SMCR"). SMCR is the FCA's framework for regulating individuals in the financial services sector and has, since 6 December 2019, applied to all firms authorised by the FCA under Financial Services and Markets Act 2000 (the "FSMA 2000").

The SMCR requires firms to apply the FIT Test to assess the fitness and propriety of their employees performing Senior Management Functions ("SMFs"), Certification Functions ("CFs") or non-executive director ("NED") roles. For certain more senior roles, firms must obtain prior regulatory approval for candidates. SMCR firms must assess the fitness and propriety of those performing SMF and CF functions on an ongoing basis and, as a minimum, once a year, as well as whenever there has been a disciplinary matter or relevant investigation matter, and when appointing any SMFs, CFs and previously non-approved NEDs.

Anecdotally, we are aware of situations where the conduct of individuals has been investigated by a firm, and while the firm may satisfy itself, having conducted its review, that the individual can still be certified "fit", the FCA may reach a different conclusion (when they are notified of the matter pursuant to Principle 11). For its part, the FCA may decide that the concerns do not meet its thresholds to open an investigation into the conduct, issue a warning notice or otherwise take enforcement action. However, that may not be the end of the matter for the individual, and the issue can remain an unaddressed blemish on their regulatory record. In these situations, the individual may become stuck in a form of regulatory limbo, for example, where an application to extend the scope of their permission to match their evolving role within a firm is denied. In such circumstances, while the individual remains certified under the SMCR, they may find themselves tethered to a certain role, unable to progress.

What, then, are the implications for individuals with a "regulatory history"? As discussed, this is a factor which may weigh negatively during a permission or approval application and is not limited to conduct in the UK should the individual's conduct in another jurisdiction potentially go to their integrity.

Nevertheless, it is possible to overcome a regulatory history, but clearly, any application must be presented carefully and tactfully.

FCA scrutiny of permission applications

The FCA authorisation unit carefully scrutinizes non-routine permission applications. The regulator will interrogate an applicant's regulatory history and conduct interviews and liaise with their domestic and overseas counterparts as relevant to the individual's regulatory history. As demonstrated by the FCA's recent announcement in relation to Woodford, the FCA will collaborate with other regulators to ensure they are properly informed of the context of applications.

Our experience is that the authorisation unit at the FCA will approach challenging and non-routine applications with an open mind. The FCA will be particularly interested in probing any allegation that the individual misled their previous firm's control functions and/or regulators. They will dissect the steps taken since any wrongdoing which are claimed to have rehabilitated the applicant. The FCA will also speak to the individual's previous employer at which the disclosed conduct took place. In some cases, the approach of firms to resolving an investigation into serious misconduct may prejudice the individual such that this may need explaining to the FCA. For instance, in the UK (and elsewhere), in order to be eligible for a negotiated settlement to end a criminal investigation, such as a deferred prosecution agreement, firms must co-operate with the investigation. In doing so, a firm will typically have to admit wrongdoing which will include misconduct on the part of certain staff. These admissions cannot be challenged by the individuals concerned and may over-play the culpability of these individuals in order to suit the firm's overriding objective.

While the importance of demonstrating rehabilitation for certain individual applicants cannot be overstated, full and frank disclosure of past regulatory and associated events and other conduct is paramount. If in doubt, disclose. Our experience is that the FCA expects fulsome disclosure with respect to an individual's regulatory and business history, as opposed to approaching the relevant application questions in a narrow "box-ticking" manner. The FCA will not appreciate learning independently of negative information that the applicant could have communicated upfront.

Next, applicants should carefully consider the role which they intend to play within the firm, whether they are properly qualified to undertake it, and whether there would be adequate checks and balances on their autonomy. For instance, the FCA would be more likely to look favorably on an application for a more subordinate or limited role than for a top-level executive position holding multiple SMFs. With regard to new firm authorisation applications, applicants with senior individuals who have potentially challenging regulatory histories should dedicate time to formulating a robust and comprehensive regulatory business and compliance plan prior to submission, reflecting the new firm's proposed categorization (e.g., exempt-CAD, MiFID investment manager, alternative investment fund manager). In our experience, and especially since the advent of the SMCR regime, the FCA will more closely scrutinize the fitness and propriety of those applying for SMFs alongside such individuals. Depending on the exact nature of the relevant individual's regulatory history and prior experience, the FCA may pose more questions with respect to their suitability for particular roles - Money Laundering Reporting Officer or Compliance Oversight, for example.[2]

[2] *In a published Final Notice from October 2017, the FCA refused the application of an experienced compliance officer, holding that he was not fit and proper to perform the Money Laundering Reporting Office function. In this*

Whilst all applicants hoping to perform a controlled function should carefully craft their permission applications, it would be especially prudent for individuals with a regulatory history to seek expert professional advice ahead of any engagement with the FCA. These applications are likely to be classified as "non-routine". Individuals whose applications are non-routine should expect to be interviewed by the FCA authorisations team, and possibly on more than one occasion. The FCA has a panel of external consultants with specialist knowledge of certain sectors. In our experience, they will lead the questioning and provide their recommendations to the Regulatory Transaction Committee considering the application for authorisation.

Whilst the FCA publicly states that decisions will be made on applications within six months, this relates only to "complete applications". The FCA generally only treats an application as complete once it deems its queries and requests for further information in connection with the application materials to have been satisfied; only then will the six-month decision (and scrutiny) period begin proper. Given the increased levels of information-gathering and preparation on the front-end, a quick authorisation process is not a reasonable expectation for such individuals.

Conclusions

Non-routine authorisation applications require careful management and expert guidance. Given what is at stake, the process can be time-consuming and costly. However, the FCA will approach individuals with chequered regulatory histories independently and open-mindedly if the applicant firm and the individual are forthcoming, candid and take the process seriously.

Advisers can help avoid the black mark of a refused application published in a final decision notice by communicating the rehabilitative context of the individual's recent actions and regulatory proposition. They can assist with the method, tone and substance of an application and enhance the prospects of a continued role in the regulated sector.

Approved Persons certified fit and proper by their firms may find that, if adverse conduct is reported to the FCA, the FCA prevents their permissions from being extended to new functions and roles. In these circumstances, the individual should consider instructing advisers, independent to those of their firm, to make the case that any such restriction on their permissions, even if informal, is unwarranted and that they are fit and proper.

instance, the individual "failed to demonstrate a detailed knowledge and understanding of the implications of the Firm's operating model, the money laundering and financial crime risks faced by the Firm and the processes that need to be put in place at the Firm satisfactorily to address those risks. Further he did not convey an adequate understanding of the difficulties in assessing the appropriateness of transactions for customers inherent in the Firm's business model, including a sufficient understanding of the risks arising from the Firm's ICAAP".

The Authors

Jeffrey M Bronheim
Partner

+44 (0) 20 8037 2320
Email Jeff

Ash Gulati
Special Advisor

+44 (0) 20 8036 9403
Email Ash

Tim Harris
Associate

+44 (0) 20 8036 9395
Email Tim

James R Mossetto
Associate

+44 (0) 20 8037 2327
Email James

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New York | Paris | Washington DC | London

www.cohengresser.com
info@cohengresser.com
+44 (0) 20 8037 2330

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