Directors: are you fit and proper? Trends in fit and proper person requirements and testing

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In recent years, there has been an increasing prevalence of specific tests or requirements to ensure that certain persons are appropriately “fit and proper” to undertake and continue in their roles in the workplace: this is especially the case in certain regulated industries such as financial services and health, but its beginnings can be found in broader companies legislation.

This article provides an overview of the fit and proper requirements for directors in the UK. It considers, in particular:

- The rules concerning the disqualification of unfit directors under the Company Directors Disqualification Act 1986 (CDDA).
- The increasing trend for the introduction of fit and proper persons tests in other regulatory provisions.
- A review of the fit and proper person requirements in the financial services and health sectors.
- A summary of how companies should approach fit and proper testing requirements, including pre-appointment checks by headhunters, recording procedures, and the impact on HR and settlements.
- An action list for employers, including setting up the process, common checks, and the responsibility or governance map.
- The impact that these increasing requirements are likely to have on business and the appointment of directors generally.

DISQUALIFICATION OF UNFIT DIRECTORS: GENERAL

It has long been the case that the law does not allow negligent or dishonest directors to continue as directors. The disqualification of unfit directors is governed by the CDDA.

Disqualification under the CDDA

The CDDA provides that a court can make a disqualification order against a person preventing them from being a director of a company for a specified period. This order also prevents a disqualified director from:

- Acting as a receiver of a company's property.
- Being in any way concerned with the promotion, formation or management of a company, except with the leave of the court.
- Being an insolvency practitioner.

The period of disqualification can be up to a maximum of 15 years and depends on the powers of the court under the particular section(s) of the CDDA under which the disqualification order is made.

There are a number of routes to disqualification, some of which lead to a compulsory disqualification, others to a discretionary one. The kind of scenarios which may be caught by the CDDA include:

- Being a director in insolvency situations.
- Being a director of a company which breaches competition law.
- Being convicted of:
  - an indictable offence in connection with the promotion, formation or management of a company; or
  - a summary offence for breaching provisions of company law.
- Being a director of a company which consistently breaches companies legislation, such as failing to file company accounts.
- Committing fraud in a winding up.
- Being an undischarged bankrupt.

There is also a general discretionary ground where, following investigation, the Secretary of State can apply to the court if he believes that it is expedient and in the public interest for a disqualification order to be made.

Certain sections of the CDDA also require the court to consider specifically the “fitness” of a director in addition to the activity caught by the CDDA. For example, the court may make a disqualification order against a person who is a director of a company which becomes insolvent only if the court is also satisfied that the director's conduct makes him unfit to be concerned in the management of a company. There is a schedule to the CDDA which outlines the matters to which the court must have regard, to the extent applicable, when considering if a director is unfit. Examples include:

- Any misfeasance or breach of fiduciary duty, in particular the duties of directors codified in the Companies Act 2006.
- The extent of the director's responsibility for any failure of the company to comply with the provisions of the Companies Act in question.
- The extent of the director's responsibility for the causes of the company becoming insolvent.

Proposed changes

The matters to consider when considering “fitness” are to be extended under the Small Business, Enterprise and Employment Act 2015 which is expected to amend the CDDA from April 2016. Under the strengthened regime there will be a broader list of factors to be considered when determining if someone is unfit to be a director, including the director's track record and the nature of the losses. It will also enable disqualification proceedings to be taken in the UK where there has been misconduct, or directors have been convicted, in relation to overseas companies. This obligation to consider misconduct overseas mirrors a development in the health sector and the long-established position in financial services (see below, Regulated sectors: financial services and Regulated sectors: health).

The new regime will also facilitate better working and information sharing between regulators to help inform decision making in disqualification proceedings. There is already some cross-referencing between regimes once a CDDA disqualification order is
made. For example if a director is disqualified under the CDDA, he is already unlikely to be able to:

- Sit on the board of a charity, school or police authority.
- Be a pension trustee.
- Be a registered social landlord.
- Sit on a health board or social care body.
- Be a solicitor, barrister or accountant.

**INCREASING TREND FOR FIT AND PROPER PERSON TESTING**

There are two large sectors where there have been significant recent developments in fit and proper person testing: financial services and the health sector (see below). It is clear from both the financial services and health sectors that these stringent tests have been introduced to enable regulatory sanctions against individuals in the face of failure, enabling the regulator to hold individuals to account for serious failings within the regulated organisation.

The new, more stringent (and in some instances subjective) tests reflect a view that a test which is in practice limited to basic matters such as court judgments or bankruptcy, or previous regulatory enforcement action is wholly inadequate. The greater focus on technical competence is aimed at assessing future risks to firms and markets, rather than just relying on an absence of evidence of past impropriety.

**REGULATED SECTORS: FINANCIAL SERVICES**

The Financial Services Act 2012 set out a new system for regulating financial services in the UK. This resulted in the replacement of the Financial Services Authority (FSA) with a “twin peaks” regulatory structure with the Prudential Regulation Authority (PRA) working alongside the Financial Conduct Authority (FCA).

The FCA has responsibility both for the conduct regulation of all authorised firms, working to ensure that financial markets work well, and prudential responsibility for those firms which are not prudentially regulated by the PRA, such as financial advisers, insurance brokers and most asset managers. Prudential regulation concerns promoting the safety and soundness of regulated firms and maintaining the stability of the UK financial system. The PRA is a subsidiary of the Bank of England and is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms.

**Approved persons regime**

Together the FCA and PRA operate an “approved persons” regime whereby individuals who perform one or more “controlled functions” on behalf of a regulated firm must be approved by the FCA and/or the PRA. Controlled functions include:

- Significant influence functions (SIF), for example, the firm’s directors, and other significant management functions, such as a chief risk officer.
- A limited number of customer-dealing functions.

The approved persons regime came into being for the financial services sector under the Financial Services and Markets Act 2000 (FSMA). It was, in part, a reaction to events at the long-established Barings Bank, which collapsed in 1995 after suffering huge losses due to speculative investments by one of its employees, Nick Leeson, who was based at its offices in Singapore. In particular, the stated intention was to provide greater personal accountability of senior managers and directors, particularly for omissions such as a failure to supervise. The regime is meant to provide some protection to the UK financial system and its consumers by overseeing the quality of the individuals performing controlled functions.

In the aftermath of the 2007-08 financial crisis the FSA conducted a review to identify the regulatory lessons to be learned. One of the key recommendations was that the FSA should increase the rigour of its day-to-day supervision by introducing so-called “intensive supervision”. Among other things this led the FSA to review its approach to the significant influence controlled functions and introduce a robust interview process for some of those seeking to be appointed to a SIF. In particular, the new process placed a greater emphasis than before on assessing competence, including expecting senior management to be able to demonstrate their understanding of the inherent risks in the business/markets and to articulate what plans are in place to mitigate the risk of failure. It warned that in the future it would take “tough enforcement action” against approved persons where it found competence failures, not just in cases of dishonesty or lack of integrity.

The FCA states that it takes a risk-based approach to the SIF interview process and will typically only interview those applying for certain designated roles, such as a senior independent director or audit committee chair, at those firms “that pose the greatest risk to our objectives”, which would usually be the largest firms. However the FCA can decide to interview any candidate nominated to perform a SIF role at any firm if they have concerns. Similarly the PRA will normally interview candidates for the most senior roles at the largest firms but can use its discretion to interview candidates from other firms. If firms are dual-regulated, it is possible that a co-ordinated joint interview will be organised.

**Fit and proper test for approved persons**

Individuals can only be approved where the FCA or PRA is satisfied that a candidate is “fit and proper” to perform the controlled function(s), and approval must be obtained before a person can perform that function. The approved person regime is intended to complement the regulation of the authorised firm for which the approved person(s) performs the function.

The fit and proper test for approved persons, known as FIT, is laid out in the FCA’s and PRA’s Handbooks. The test assesses the following:

- Honesty, integrity and reputation.
- Competence and credibility.
- Financial soundness.

These matters are considered in greater detail below.

**Honesty, integrity and reputation.** In determining a person’s honesty, integrity and reputation, the FCA or PRA will have regard to all relevant matters including, but not limited to, a specific list set out in the Handbook. To illustrate the breadth of the test, these include, in simplified form, whether:

- The person has been convicted of any criminal offence.
- The person has been the subject of any adverse finding or settlement.
- The person has been the subject of earlier investigations.
- The person is or has been the subject of disciplinary or criminal proceedings.
- The person has contravened the requirements or standards of the UK regulatory system or other UK regulatory authorities.
- The person has been a director, partner, or concerned in the management, of a business that has gone into insolvency, liquidation or administration.
- The person has been dismissed, or asked to resign and resigned, from employment or from a position of trust, fiduciary appointment or similar.
- The person has ever been disqualified from acting as a director or disqualified from acting in any managerial capacity.
In the past, the person has been candid and truthful in all his dealings with any regulatory body.

The person demonstrates a readiness and willingness to comply with the requirements and standards of the regulatory system and with other legal, regulatory and professional requirements and standards.

As is now being proposed for the CDCA, it does not matter whether these breaches have arisen in the UK or elsewhere. Also notable is that the regulator has discretion: for example, a person may still pass the test if they have a criminal conviction, but it is not deemed relevant due to the particular circumstances, such as its seriousness, its relevance to the role, the passage of time and/or evidence of rehabilitation.

**Competence and capability.** Broadly speaking this part of the FIT test is about satisfying the appropriate regulator’s requirements for experience and training and that the person has adequate time to perform the role. In some cases more detailed requirements, such as those contained in chapter 4 of the regulators’ Senior Management Arrangements, Systems and Controls (SYSC), will apply. In addition, Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms (Capital Requirements Regulation) requires significant firms that are subject to the Regulation to ensure that board members do not combine one executive directorship with more than two non-executive directorships, or hold more than four non-executive directorships.

**Financial soundness.** In determining a person’s financial soundness, the FCA or PRA will have regard to any relevant factors, including whether:

- The person has been the subject of any judgment debt or award, in the UK or elsewhere, that remains outstanding or was not satisfied within a reasonable period.
- In the UK or elsewhere, the person has:
  - made any arrangements with his creditors;
  - filed for bankruptcy;
  - had a bankruptcy petition served on him;
  - been adjudged bankrupt;
  - been the subject of a bankruptcy restrictions order (including an interim bankruptcy restrictions order);
  - offered a bankruptcy restrictions undertaking;
  - had assets sequestrated; or
  - been involved in proceedings relating to any of these things.

**Continuing duties post-approval**

Once approved, approved persons must continue to comply with FIT, SYSC and the Statements of Principle and Code of Practice for Approved Persons and have a duty to report to the authorised firm and to their regulator (be it the FCA or PRA) any matter that may impact on their ongoing fitness and propriety. Approved persons must also comply with the Statements of Principle and the Code of Practice for Approved Persons set out in the APER section of the handbook. These Statements of Principle describe the conduct that the FCA or PRA requires and expects of the individuals it approves.

**Changes to the approved persons regime**

Changes are afoot to the approved persons regime. Both the PRA and FCA have been consulting on changing and expanding the regime following the Libor scandal, concerns about professional standards and culture in the banking sector, and the resulting recommendations from the Parliamentary Commission on Banking Standards. There is also a need to introduce certain measures to comply with the Financial Services (Banking Reform) Act 2013 and (in the case of insurance companies) the requirements of Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II Directive).

The FCA and PRA will be bringing in a new Senior Managers Regime (SMR) for banks which will apply to those carrying out a Senior Management Function (SMF). These individuals will be subject to regulatory approval (and sometimes be interviewed by the regulator(s)). These proposals do not currently extend to all independent NEDs, with the scope within boards currently limited to the board committee chairs and the SID. Firms will have to allocate certain responsibilities to Senior Managers, and regularly review their fitness and propriety. The idea is to enhance individual accountability and clarify the specific responsibilities of senior managers. The SMR will cover a smaller group of people than the current approved persons regime, but there will also be a certification regime which will require firms to assess the fitness and propriety of certain other employees who could pose a risk of significant harm to the firm or any of its customers. Together these two regimes will apply to a larger number of individuals within a firm than the approved persons regime does today.

The previous FIT standards of fitness and propriety will not change much in essence, but what is likely is that more evidence with be required to assess and certify fitness and propriety. A key change is that the obligation to certify fitness and propriety will move from the regulator to the regulated firm (as we see is the case in the new regime for the health sector described below). This will put the onus on HR departments to ensure that gaps in internal processes do not lead to an erroneous certification that a person is fit and proper and that the regulatory requirements for evidence collection, when assessing candidates for SMFs or certification functions, are met.

A new Code of Conduct will replace the current Statements of Principle and Code of Practice for Approved Persons. For insurance companies, the PRA is also consulting on plans to create a new Senior Insurance Managers Regime (SiMR) this has similarities to the SMR, but will not be quite so onerous. There will also be a designated group of “key function holders” about whom assessments of fitness and propriety would need to be made. A new set of Conduct Standards will apply to both groups, in an effort to ensure that senior persons running insurers, or holding key functions, also act with integrity, honesty and skill.

The fit and proper person tests, in both financial services and health, form only a part of a host of new regulations to force standards up following independent recommendations being welcomed by government, as seen in both the Parliamentary Commission for Banking, and in Robert Francis’s Public Inquiry into Mid Staffordshire.

**REGULATED SECTORS: HEALTH**

**Monitor licence conditions**

Monitor is the sector regulator for health, with a core duty to protect and promote patients’ interests; it is also the independent regulator for NHS foundation trusts. All providers of NHS services (including independent providers of NHS services) must comply with certain of Monitor’s licence conditions, one of which ensures that no person who is an unfit person may become or continue as a director (or governor in the case of foundation trusts), except with the approval in writing of Monitor. The tests for fitness in Monitor’s general licence condition G4 are fairly basic, limited to matters such as bankruptcy, convictions, and disqualification under the CCDA. The test does not extend to matters of behaviour, or having appropriate skills and experience.

**Care Quality Commission fit and proper person test**

The Care Quality Commission (CQC) is the regulator for all health and social care services, and aims to ensure that people are provided with safe, effective, compassionate and high-quality care. It monitors, inspects and regulates services to make sure they meet global.practicallaw.com/corpgov-mjg
fundamental standards of quality and safety. The CQC has introduced new requirements and fundamental standards for all care providers from April 2015 to assure service users about the standards of care they should receive. Two regulations that form part of these changes came into force early on 27 November 2014 for NHS bodies:

• Regulation 5: fit and proper persons: directors.

• Regulation 20: duty of candour.

The Care Quality Commission’s fit and proper persons test (FPPT) brought in by Regulation 5 is a new test which is much more rigorous than the test in the Monitor licence, and broader in its approach. Like in the banking sector its introduction is linked to strengthening corporate accountability and individual responsibility, and rebuilding confidence; in this case the health sector following scandals at Winterbourne View and Mid-Staffordshire hospital. They want to ensure that the “controlling mind” of a care provider is fit for that role. In his final report on the Public Inquiry into the deaths at the Mid Staffordshire NHS Foundation Trust, Robert Francis QC recommended the introduction of a test which would disqualify individuals on the grounds of serious misconduct or incompetence and which included criteria for fitness which included a minimum level of experience and/or training.

Since 1 April 2015 CQC’s FPPT has also applied to all independent service providers (except partnerships) providing regulated services.). Its application, whether in the NHS or independent sector, is limited to board directors and those performing equivalent functions by which is meant executive and non-executive, permanent, interim and associate board director positions, irrespective of their voting rights. There is relevance to the private sector both in terms of executives taking NED positions in the NHS and of course by virtue of the fact that the scope of Regulation 5 has been extended to non-NHS regulated providers from 1 April 2015.

The CQC test, in addition to the base level matters we have seen elsewhere, includes assessments that the individual:

• Is of good character (requiring, among other things, checking for strikings off from professional registers).

• Has the qualifications, competence, skills and experience necessary.

• Is able by reasons of their health, after reasonable adjustments are made, to perform their role.

• Has not been responsible for, been privy to, contributed to, or facilitated any serious misconduct or mismanagement (whether unlawful or not) in the course of carrying on a regulated activity, either in England, or similar activity overseas.

• Does not meet some specified grounds for unfitness (including being on a children or vulnerable adults’ barred list).

There is an onus on the provider proactively seeking information to assure themselves that the test criteria are met on appointment, and then keeping the fitness of their directors under review. The implication is that it is not enough to rely on self-certification of directors, which had been the most common practice in NHS bodies under the Monitor licence test. The chairmen of providers must personally certify that their board directors meet the test.

The aspect of the test which is potentially the most challenging to assess is whether or not the individual has not been responsible for, been privy to, contributed to, or facilitated any serious misconduct or mismanagement in the course of carrying on a regulated activity (see above). This test criterion is not time bound, or limited to activity in the UK, so in theory could require a look back over an individual’s entire career in the health sector. Then there is the difficulty of what would constitute serious misconduct or mismanagement, on which there is little guidance at this point. CQC itself is probably having to apply some early judgement in this area as the Health Service Journal recently reported that 20 cases had been referred by whistleblowers about directors alleged not to be fit and proper “because of their past action or behaviour”, quite possibly in alleged contravention of this part of the test. Cases such as these will in time illustrate how CQC interprets serious misconduct or mismanagement.

COMPANIES: HOW SHOULD THE NEW FIT AND PROPER PERSONS TEST BE APPROACHED?

Pre-appointment checks for head hunters

Certainly in banking and health, head hunters have already long been doing pre-appointment checks to varying degrees. However, a likely impact of the more stringent tests introduced, or to be introduced, and the increasing onus on organisations to approve the individuals in question themselves, is that these head-hunter checks will often be undertaken earlier in the process to ensure that candidates who would very clearly fail the test are not put forward to the client at all. Head hunters are unlikely to undertake the detailed checks necessary on final appointees on behalf of organisations, as the latter are likely to want undertake those themselves given the implications, and the need anyway for ongoing reviews of fitness and propriety of individuals once they are in post.

Recording procedures from organisations

It is essential that organisations to whom the fit and proper person tests apply adopt appropriate policies and procedures, and document the process they have followed in certifying that someone is fit and proper.

As well as documenting the testing process, it is becoming increasingly important for organisations to document properly internal failings and the extent of the involvement of senior individuals in the matter. This will be needed in the event that third parties want to check on a candidate’s background when he or she is applying for a director or senior management role at the third party. The third party will of course be keen to understand the extent of the individual’s involvement in such failings. Legal advice on the conflicting requirements of the Data Protection Act, and not keeping on record information about an individual for longer than is necessary, may need to be sought to get the balance right.

Impact on HR/settlement agreements

Organisations need to rise to these new challenges and often HR, in tandem with the company secretary and/or inhouse legal and compliance team(s) will lead on the design of appropriate processes. The responsibility for getting these processes right cannot be overstated whether in respect of the impact on the reputation of the individuals concerned, or the organisation by association.

One by-product of this increasing trend for fit and proper purpose testing may well be that the practice of hiding failings in settlement agreements will become less accepted as a practice. Indeed those in the financial services sector will already be aware of the regulators’ position that the requirements of their principles and rules override any duty of confidentiality entered into between a financial participant and its employee. Failing to disclose relevant information to the FCA or PRA may be a criminal offence under section 398 of FSMA. Similarly, SUP 10A.15 / SUP 10B.13 make it clear that a firm’s duty to its regulator(s) overrides the terms of any compromise agreement.

AN ACTION LIST FOR EMPLOYERS

Setting up the process

When setting up the fit and proper testing processes, employers must consider a number of elements, including:

• A clear review of the requirements, source documents and guidance.

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Understanding the scope of the process and to whom it applies.
Developing processes and procedures, with a clear allocation of responsibilities, and deciding on the mix of reliance on self-certification and proactive checks.
Documenting the process, and evidencing decisions.
Meeting any information requirements of the relevant regulator.
Introducing processes to ensure ongoing review.
Understanding the impact on employment contracts and constitutional documents.

Albeit in a different context, the FCA’s Financial Crime: a guide for firms recommends that firms carry out vetting of staff, appropriate to their roles.

Common checks
Clearly certain tests will be sector specific, and require specialised advice but there are a number of checks and services which can be undertaken easily, such as:

- Companies House keeps a register of disqualified directors which can be searched by name, and the Insolvency Service also keeps a register of the disqualifications it has carried out. Both are available here: www.gov.uk/search-the-register-of-disqualified-company-directors

- The Criminal Records Bureau (CRB) and the Independent Safeguarding Authority (ISA) have merged into the Disclosure and Barring Service (DBS). What were CRB checks are now called DBS checks and these can be requested via the Disclosure and Barring Service (England and Wales) at www.gov.uk/government/organisations/disclosure-and-barring-service

- Some overseas criminal records are held on the Police National Computer and will be revealed as part of a DBS check. The DBS website explains how to access further information from a list of countries at: www.gov.uk/government/publications/criminal-records-checks-for-overseas-applicants

- If necessary, embassies or high commissions may also be able to assist through the FCO.

- The Financial Services Register holds details of most adverse enforcement actions against approved persons by the FCA, PRA or the FSA.

Responsibility or governance map
Under the proposed FCA and PRA schemes there are requirements for firms to produce a responsibility map, or governance map: single documents which, among other things, must set out the firm’s overall framework for the allocation of responsibilities to individuals, and the governance and management arrangements. The aim is to ensure that, when looked at collectively, the allocation of responsibilities does not leave any gaps in accountability (something which directors may have to confirm annually). This mapping exercise may be something which proves useful for other sectors to adopt voluntarily as a tool to assess the adequacy of their own internal accountability structures and lines of responsibility.

CONCLUSION: IMPACT ON THE INDIVIDUAL AND THE MARKET

The media make much of the impact of all of this scrutiny on individuals and it may well be the case that there are knock-on effects. Many head hunters report that senior experienced individuals are in short supply when it comes to applying for non-executive positions in listed companies: the unwavering gaze of shareholders and regulators being an oft-quoted reason for this. Some sectors report that aspirant directors are thinking twice before applying for approved posts for the same reasons.

It is also reasonable to assume that incumbents in both executive and non-executive positions will be far more interested in corporate documents, and the record of who made which decisions. If this perception of increased scrutiny prevails then there may also be an impact on remuneration.

Finally, beyond the impact on individuals, what about the type of people attracted to this brave new world? It is perhaps inevitable that this world of oversight attracts only more risk averse personalities, and perhaps even those who have no track record of any risk taking at all, with all the attendant threats to entrepreneurship that this suggests.

So the message is clear. A fit and proper person test is being applied in the most regulated sectors in the country and there is no reason to think it will stop there. Once applied, the higher you go in the management chain the more onerous this becomes. Individual sectors have their nuances, but the notion of being unable to hire inappropriate directors is now inescapable for most organisations.
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