

Non-Financial Misconduct

A summary

Introduction

The reputation of the financial services sector has been badly affected by scandals and allegations relating not only to the way that products perform or funds are protected, but also in relation to "non-financial misconduct". A number of the most widely-reported and notorious incidents have arisen from conduct largely or entirely outside the workplace.

The UK's financial regulators - the Financial Conduct Authority ("FCA") and the Prudential Regulatory Authority ("PRA") - have, in recent years, begun to respond to this public perception and to the need to tackle the behaviour underpinning it. Responding appropriately to these serious and sensitive issues has not been an easy task, in large part because their regulatory toolkit needs to be updated to meet the challenge.

In September 2023, both regulators issued linked consultation papers (CP 23/20 and CP 18/23) which marked a significant step forward in making the necessary substantive changes to tackle the effect of "non-financial misconduct" on the industry. The consultations closed in December 2023. The resulting policy statements and finalised changes to the regulators' handbook rules and guidance are expected in the second half of 2024.

Now, as that time approaches, we begin a series of articles on the proposed changes and what they mean for the industry, with a summary of the proposals and their potential significance.

Overview of Proposals

The regulators' collective view is that safer and more diverse workplaces lead to better outcomes for the market and for consumers. The consultation papers therefore also focus on targets and reporting in relation to diversity and inclusion and the measures on non-financial misconduct need to be seen as part of the regulators' drive to reform the perceived culture of certain firms.

The new rules and guidance will apply to firms holding a Part 4A permission under the Financial Services and Markets Act 2000. This is a very wide group, spanning the biggest banks to sole trader IFAs and small businesses authorised to offer or broker consumer credit.

Notable omissions include payment services firms and electronic money institutions which are not subject to the FCA's "Senior Management and Certification Regime" ("SMCR"). The FCA has not ruled out future, similar, reforms to these and other sectors of the market, such as credit reference agencies.

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The proposals involve including non-financial misconduct in three key parts of the regulatory framework:

- the Code of Conduct ("**COCON**") – these are the FCA's rules governing the conduct of senior managers and most other staff at authorised financial services firms;
- the Fit and Proper test for Employees and Senior Personnel ("**FIT**") – this part of the handbook contains guidance on how the FCA will and a firm should assess whether a person (e.g. an applicant for a senior management or certification function role) is fit and proper; and
- the suitability threshold condition (set out in "**COND**") – the suitability threshold condition is one of the 5 basic conditions a firm must meet if it is to be and remain authorised.

Conduct Rules

COCON imposes conduct rules on board members and employees of financial services firms (with some exceptions, for example for facilities and security staff). Among other things, COCON requires all in-scope staff to act with integrity and with due skill, care and diligence (primarily when engaging in conduct that forms part of the firm's regulated activities, though the rules can relate to other activities, particularly for employees of banks). COCON requires senior managers to ensure the rules are complied with.

The changes to COCON bring into scope non-financial misconduct by relevant employees towards other employees or those who provide services to the firm or group. This includes conduct which: violates someone's dignity;

creates an intimidating/hostile/degrading environment; or is actually offensive, intimidating or violent. It includes bullying and sexual harassment.

There are limitations – conduct which is not "serious" is excluded, as is conduct arising in someone's personal life. There is guidance on determining whether the conduct will be excluded for these reasons but, even if it is, the behaviour may still be relevant to fitness and propriety. A firm is not permitted to have an individual performing a senior management function or certification function (or, in practice, any function) who is not fit and proper.

The effect of the changes would be to allow the FCA to investigate and take enforcement action against individuals who show a lack of integrity by engaging in behaviour such as bullying and sexual harassment in the workplace. The FCA would also be able to investigate and discipline managers who have failed to take action to protect staff for whom they are responsible against such behaviour. The action the FCA might take includes the imposition of financial penalties, public censures and even prohibition from the industry.

FIT

As noted above, any senior manager or member of conduct rules staff must be fit and proper to perform their functions. In reality, the FCA is likely to take a negative view of any staff who are not fit and proper – the provisions in COND allow the regulator to consider a firm's connection with any person when looking at the fitness of the firm as a whole.

The test in FIT is divided into 3 sections and the key one for these purposes is "honesty, integrity and reputation". The amendments to

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FIT are explicit that misconduct in a person's private life, including but not limited to the commission of sexual offences (or similar misconduct not resulting in a conviction), can be relevant to the overall assessment of whether person is fit and proper to work in financial services.

The FCA had previously tried to use its enforcement powers to create this fitness and propriety requirement. However, this had been a slow and highly contentious process, with significant pushback from the Upper Tribunal. The new amendments circumvent those problems and bring plainly into the consideration of firms and the regulator sensitive aspects of individuals' private lives. The FCA will be able to prohibit individuals from the industry for conduct arising entirely outside the workplace. It has sought to do this before, with some degree of success, but judicial rulings have had a limiting effect on the type and number of cases the regulator has been able to take.

COND

The FCA has always been able to assess whether a firm meets the minimum standards of fitness and propriety by reference to the firm's connections with other individuals or entities. COND has now been updated to confirm that this means the FCA can assess a firm's fitness and propriety by reference to its connection with individuals who have engaged in non-financial misconduct, such as sexual offending or who have been dismissed from employment due to sexual harassment or bullying.

Summary

In addition to the above, the PRA indicated in its consultation that it will also take into account, when assessing fitness and propriety, behaviour such as bullying, discrimination and harassment. The regulators are at last reflecting the tectonic cultural shifts which have taken place over the last few years.

However, it remains to be seen how the proposals will translate into finalised amendments to the handbook and then how those rules might form the basis of meaningful enforcement or supervisory action in future. Beyond those big picture points, there are day-to-day regulatory and employment law ramifications for firms, not just when these rules are breached, but in putting place the necessary infrastructure to ensure compliance.

In the coming weeks and months, ahead of the release of the finalised policy statements and following them, we will be taking some deeper dives into the effect these changes will have on firms, on individuals and on how the regulators supervise and enforce in the market.

For further information and advice, **please contact Sam Clyndes.**



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