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Insights

APPLYING THE FCA'S PROPOSED NEW GUIDANCE ON NON-FINANCIAL MISCONDUCT

PRACTICAL AND LEGAL CHALLENGES FOR FIRMS AND THEIR HR AND COMPLIANCE TEAMS

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SUMMARY

Non-financial misconduct in financial services firms is back at the top of the agenda following the concurrent publication of the FCA's Consultation Paper 20/23 (Diversity and inclusion in the financial sector – working together to drive change) and the PRA's Consultation Paper 18/23 (Diversity and inclusion in PRA-regulated firms). The PRA and FCA appear to be agreed that (a) non-financial misconduct incidents are relevant when considering whether an individual has acted with integrity and that (b) for senior managers and certification staff, sometimes behaviour in their personal lives that is unconnected to their job will be relevant to their fitness and propriety to work in financial services. How are HR and Compliance professionals to respond to the new role of moral arbiter that these proposed guidelines point towards, and where will the practical and legal challenges arise?

BACKGROUND TO THE PAPERS

On 25 September 2023, the FCA and PRA published their long-awaited consultation papers on diversity and inclusion in the financial sector:

- The FCA's consultation paper CP20/23
- The PRA's consultation paper 18/23

These consultation papers follow on from the regulators' 2021 joint Discussion Paper (DP21/2) and reflect the increasing recognition of the need to improve D&I outcomes within regulated firms and accelerate D&I change across the financial sector.

Among other matters, the papers seek to clarify and enhance regulators' expectations around non-financial misconduct (for example bullying, sexual harassment and racially motivated misconduct)

and how it interacts with the regulatory concept of integrity, which is core to various SMCR processes (e.g. fitness and propriety assessments, Conduct Rule breach reporting, regulatory references). There are particularly important proposals tucked away in the Appendix to the FCA's consultation paper. If the proposed new guidance is adopted, all firms will need to consider whether an incident of non-financial misconduct that occurs may constitute a breach of the Conduct Rules and (where the individual concerned is a senior manager or certification staff member) whether it affects the firm's view of their fitness and propriety.

WHAT DOES THE PROPOSED NEW GUIDANCE SAY ABOUT NON-FINANCIAL MISCONDUCT AND INTEGRITY?

The draft guidance appended to CP20/23 suggests that the FCA wishes to embark upon a wholesale redefinition of the concept of integrity, using the medium of non-binding Handbook guidance. It proposes to do this apparently without reference to the regulatory case law on integrity. This development has the clear potential to create legal risk for firms if, in following the regulators' suggested approach (set out in non-binding guidance) to how the concept of integrity should be interpreted, they go beyond what the law says and thereby place themselves at risk of legal challenge from the individuals concerned.

The FCA proposes to introduce guidance stating that conduct that is inconsistent with a good working environment – being an environment in which each employee feels respected, valued and able to give their best, and is treated fairly, with dignity and respect – may be a breach of Conduct Rule 1 ("You must act with integrity"). Since integrity is at the heart of the regulatory definition of fitness and propriety, it follows that conduct that is inconsistent with a good working environment (and thus demonstrates a lack of integrity) could also be relevant to a fitness and propriety assessment. So, the FCA is essentially proposing that an individual may lack integrity purely as a result of the way their behaviour makes other people feel. This is not the position at law, which is perhaps the reason why the FCA is proposing an 'exemption clause' from liability for those who do not have (or claim not to have) malicious intentions.

On this, the FCA proposes to offer a 'get out of jail free' card – to be played once only, as we read it, unless the matter concerns sexual harassment, in which case it cannot be used at all – to individuals whose behaviour causes offence but who (i) do not intend to cause offence, (ii) do not realise they are doing so and (iii) are not reckless as to the effect of their conduct. Recklessness, in regulatory law, requires the person in question to have a subjective appreciation that a risk exists, before disregarding it – meaning that the provision outlined above appears to exonerate an individual who genuinely but unreasonably has no appreciation of the impact of their behaviour upon others (unless they have been engaged in sexual harassment, which is specifically carved out of the scope of the exemption). We anticipate that this 'pass' would only be available once – as presumably an individual who had been reported for behaving offensively to others once would have been reprimanded and, on any recurrence of the behaviour, would be at best reckless as to its

effect (having been put on notice of the risk that it would cause offence to others). This provision places a considerable burden on the HR and Compliance professionals tasked with deciding what the individual was and was not aware of when they chose to act in a particular way towards a colleague. There will also be process challenges in ensuring a consistent approach.

More obviously contrary to the settled legal position is the proposed new guidance stating that misconduct in a person's private life may be relevant to their fitness and propriety to work in financial services, even where there is "*little or no risk of it being repeated in their form for their firm*". The Upper Tribunal in *Jon Frensham v FCA* held, following the SRA jurisprudence, that "*provisions requiring professional persons to act with integrity or to be of sufficient repute may reach into private life only when conduct that is part of a person's private life realistically touches on their practice of the profession concerned. The conduct must be qualitatively relevant because it engages the standard of behaviour set out in the regulatory code concerned.*" It is difficult to see how these two positions can be reconciled.

Finally, the section of the guidance that discusses whether or not a person's non-financial misconduct outside work may demonstrate that they lack integrity employs some highly subjective concepts that will, on the face of it, require the HR and Compliance professionals making decisions concerning fitness and propriety to apply moral judgement rather than legal or regulatory analysis. The proposed new guidance on the fit and proper test states that misconduct in a person's private life may be relevant to their fitness and propriety to work in financial services because "*it may show that a person lacks moral soundness, rectitude and steady adherence to an ethical code*" and that this will be the case if the conduct is "*disgraceful or morally reprehensible or otherwise sufficiently serious*". We wonder whether, if this particular provision is included, it will force regulated firms to adopt formal behavioural codes (in addition to the values statements that many have already adopted) so as to reduce their legal risk by setting rules about the behavioural expectations that these new provisions will ask them to police.

CONCLUSION

We appreciate the FCA's progressive culture agenda and in particular their emphasis on inclusion, diversity and encouraging psychological safety in the workplace as a risk management tool. However, we consider that the proposed new guidance on non-financial misconduct risks placing a disproportionate burden of complexity on the HR and Compliance professionals tasked with implementing it. In our view, misconduct outside work that is not criminal in nature should be excluded from the fitness and propriety test, as it is excluded from the scope of the Conduct Rules. To do otherwise risks both regulatory overreach and a regime that is impossible for firms to implement without creating disproportionate legal risk for firms.

The feedback period for the consultation is open until 18 December with the final rules and guidance to be published in 2024.

If you would like to discuss how the new potential guidance on non-financial misconduct may affect your firm, please contact Polly James.

The authors would like to thank trainee solicitor, Betsy Bowman-Hood, for her input into this article.

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