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NON-FINANCIAL MISCONDUCT IN FINANCIAL SERVICES REGULATION – WHERE DO WE STAND?

– THOUGHT LEADERSHIP

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Three new decisions from the Financial Conduct Authority (FCA) show renewed focus on "non-financial misconduct," a term covering issues such as sexual misconduct and bullying, but a recent High Court finding against another regulator, the Solicitors Regulation Authority (SRA), potentially undermines the FCA approach. This briefing explores, amongst other issues: when non-financial misconduct may amount to a breach of the Conduct Rules; how non-financial misconduct should be assessed; what the regulatory expectations on firms are to conduct investigations and notify the regulator; how the FCA views culture and psychological safety and links these with its objectives; and will there be a shift in stance as the High Court has recently cautioned regulators against being "dogmatic."

The FCA expects high standards of character, probity and fitness and properness from those who operate in the financial services industry, and will take action to ensure these standards are maintained.

—**MARK STEWARD,**
Executive Director,
Enforcement and Market Oversight

What is the FCA's stance?

In September 2018, the Women and Equalities Committee published its report on sexual harassment in the workplace. In response, Megan Butler, then the FCA's Executive Director of Supervision (Investment, Wholesale and Specialists Division) wrote a well-publicised letter explaining the three main bases on which the FCA sees sexual misconduct as falling within the scope of the financial services regulatory framework: through supervision of workplace culture; through fitness and propriety assessments; and, potentially, through enforcement of the Conduct Rules themselves. The letter suggested how the FCA draws a link between non-financial misconduct, culture, psychological safety and the FCA's statutory objectives.

In a speech shortly afterwards, in December 2018, Christopher Woolard, then Executive Director of Strategy and Competition, reiterated that message to firms with the aphorism *"non-financial misconduct is misconduct, plain and simple".*

More recently, in November 2020, Jonathan Davidson, Executive Director of Supervision (Retail and Authorisations) reiterated that the FCA has increased its focus on non-financial misconduct, drawing attention to the prohibition of three individuals following convictions for sexual offences. In announcing those prohibitions Mark Steward, Executive Director of Enforcement and Market Oversight, said:

"The FCA expects high standards of character, probity and fitness and properness from those who operate in the financial services industry, and will take action to ensure these standards are maintained."

At the same time, however, in SRA v Beckwith [2020] EWHC 3231 (Admin) the High Court has sounded a note of caution to all professional services regulators against being "*dogmatic*" and treating popular outcry as "*proof that a particular set of events gives rise to any matter falling within a regulator's remit.*"

Conduct Rules

Firms investigating allegations of non-financial misconduct will typically need to consider whether the allegations may give rise to a breach of the Individual Conduct Rules. This may be to determine whether there is a requirement to notify the regulator immediately or following a disciplinary investigation for the purposes of the annual report to the FCA pursuant to section 64C FSMA.

The Conduct Rules include the obligation to act with integrity (Rule 1). As Megan Butler indicated in her 2018 letter to the Women and Equalities Committee, non-financial misconduct could, in principle, give rise to a breach of this Rule.

When might non-financial misconduct be a breach?

- The Conduct Rules are capable of applying to both regulated and unregulated activities.
- For Conduct Rule staff in banks the Conduct Rules apply to the performance of any functions relating to the carrying on of activities by the firm (whether regulated or not). For Conduct Rule staff in firms other than banks, the Conduct Rules are, broadly speaking, limited to regulated activities.
- The COCON section of the FCA Handbook includes includes a non-exhaustive list of examples of conduct that would be in breach of the requirement to act with integrity. The list includes various examples of dishonest or misleading conduct in the course of providing financial services, including misleading clients, misleading the regulators and misleading others in the firm. But there are no examples of non-financial misconduct.
- Given these parameters, the circumstances in which non-financial misconduct will be within scope of the Conduct Rules may be limited. Even for banks, where the Conduct Rules apply to any of the firm's activities whether regulated or not, the rules apply only *in relation to the performance of functions relating to the firm's activities.*
- Whilst there is some uncertainty about the nature of the connection required by the words "*in relation to*" in this context, it is clear that there would need to be a sufficiently close connection between the non-financial misconduct, the functions of the individual concerned and the activities of the firm for the Conduct Rules to be engaged.
- Firms need to consider whether such a sufficiently close connection exists on a case-by-case basis, and it will be sensible to seek external advice, but conduct involving a colleague occurring in a social context outside work hours, even if at a work-related event, might not have sufficient connection to fall within scope.

Fit and Proper Assessment

Firms will also need to consider whether allegations of non-financial misconduct have implications for the relevant employee's fit and proper assessment, both for the purposes of annual certification and for the purposes of being satisfied on an ongoing basis that the person is fit to continue to perform their role.

When might non-financial misconduct be relevant?

- Fit and properness is assessed by reference to honesty, integrity and reputation; competence and capability; and financial soundness. Non-financial misconduct is typically seen as potentially relevant to integrity and reputation (although cases may also involve dishonesty too) is more likely than under the Conduct Rules to be taken into account in the fit and proper assessment even where it does not occur in relation to the firm's activities.

- The FCA Handbook provides guidance as to how firms should assess honesty, integrity and reputation, as well as a non-exhaustive list of factors to be taken into account. The guidance provides that an SMCR firm determining the honesty, integrity and reputation of staff being assessed under FIT should consider all relevant matters, including those set out in FIT, whether arising in the UK or abroad. Firms should inform themselves of relevant matters, including checking for convictions for criminal offences (where possible) and contacting previous employers who have employed that candidate or person. If any staff member being assessed under FIT has a conviction for a criminal offence, the firm should consider the seriousness of and circumstances surrounding the offence, the explanation offered by that person, the relevance of the offence to the proposed role, the passage of time since the offence was committed, and evidence of the individual's rehabilitation.[1]

- FIT contains a list of factors to which the FCA and firms should have regard in assessing integrity. These focus on financial misconduct: for example, whether the person has been the subject of any adverse finding in civil proceedings, particularly in connection with investment or other financial business, misconduct or fraud; there is no express reference to non-financial misconduct.

- With regards to individuals holding senior management functions, fitness and properness might be assessed by reference to the steps they have taken against, or to prevent, non-financial misconduct by staff operating within their area of responsibility. As the FCA set out in a "Dear CEO" letter to insurance firms on 6 January 2020: *"a senior manager's failure to take steps to address non-financial misconduct could lead us to determine that they are not fit and proper".*

- In principle, this would not necessarily require or depend on action in respect of specific underlying misconduct, but instead could be based on evidence of broader cultural failings. In other words, the FCA may consider a senior manager's failure to take action to embed a healthy culture to be evidence itself of a lack of competence or, in certain circumstances, integrity.

1. As regards competence and capability, the guidance in the FCA Handbook provides that the FCA would expect an SMCR firm determining individual's competence and capability to consider convictions, dismissals and suspensions from employment for drug or alcohol abuse, or other abusive acts only in relation to a person's continuing ability to perform their role.

Understanding "integrity" and "reputation"

The list of examples of conduct that would be in breach of the requirement to act with integrity in COCON do not include non-financial misconduct, and the factors listed in FIT for assessing integrity focus only on financial misconduct. These are not exhaustive, and so do not exclude the possibility of non-financial misconduct constituting a lack of integrity or reputation, but there is no guidance in the Handbook on when that may be the case.

In the well-known case of Hoodless and Blackwell v FSA, the Financial Services and Markets Tribunal offered a definition of integrity which has been cited with approval in a variety of contexts subsequently:

In our view 'integrity' connotes moral soundness, rectitude and steady adherence to an ethical code.

However, that case concerned Hoodless and Blackwell's performance of their work as brokers and their lack of co-operation with the regulator's investigation.

There are few cases addressing the meaning of integrity in relation to non-financial misconduct.

On 5 November 2020, the FCA announced that it had prohibited Russell Jameson, Mark Horsey and Frank Cochran from working in financial services on the basis of convictions for sexual offences (the three cases are unrelated) in each case on the basis of a lack of integrity and reputation.

Jameson was a financial adviser at an authorised firm and was approved by the FCA to hold various significant influence and customer-facing functions at the firm. In July 2018, Jameson was convicted of criminal offences involving the making, possession and distribution of indecent images of children. He was sentenced to five years' imprisonment, ordered to sign the sex offenders register indefinitely, and included in the list of individuals barred from working with children or vulnerable adults.

Horsey was the sole director and shareholder of an authorised financial [advisory] firm with permission to conduct designated investment business and insurance distribution. In September 2018, Horsey was convicted of voyeurism, contrary to the Sexual Offences Act 2003. He was sentenced to nine months' imprisonment suspended for 18 months, required to complete 100 hours of unpaid work and 25 days of rehabilitation activity, and required to sign the sex offenders register.

Cochran was a director and shareholder of an authorised financial advisory firm with permission to advise on pensions, mortgages and investments. In April 2018, Cochran was convicted of sexual assault, engaging in controlling and coercive behaviour, and an offence contrary to the Protection from Harassment Act 1997. He was sentenced to seven years' imprisonment and required to sign the sex offenders register.

In issuing the prohibitions, the FCA made specific reference to comments made by the sentencing judges, including that Jameson had committed an "outrageous abuse of trust": because he had superimposed the faces of individuals known to him onto pornographic material; that Horsey's offences involved "substantial and significant planning" in order to commit this offence, including the careful positioning of mirrors and a ladder; and that Cochran's offending involved a "breach of trust" and an "abuse of power".

These specific references provide further clarity as to the behaviours that the FCA will consider relevant in assessing whether cases fall within their remit (and which will therefore assist firms grappling with how to deal with borderline cases in the workplace): trust and abuse of power are critical themes for the FCA.

Evidently these were cases involving criminal convictions for serious sexual offences and have been regarded by commentators as straightforward.

However, it is clear that the regulator takes the view that there will also be less clear-cut cases in which an individual could lack the necessary integrity and/or

reputation, even without a criminal conviction, where there is other evidence of non-financial misconduct.

What sort of conduct would fall within scope and what sort of evidence would be required? There are no financial services cases or guidance to address this question beyond the guidance given by the regulators in the speeches and letters described above and the limited guidance set out in FIT and the Enforcement Guide, neither of which refers expressly to sexual misconduct.

That leaves firms facing difficulties in how to treat a wide range of conduct, from alleged non-consensual sexual behaviour towards colleagues which does not result in a criminal conviction, through to allegations relating to sexual conduct outside work potentially extending to allegations of abusive behaviour in the context of divorce proceedings or even, perhaps, allegations of marital infidelity.

In Beckwith, the Administrative Court considered the meaning of integrity and reputation in the context of the regulatory framework applicable to solicitors, adopting reasoning that will be equally applicable to financial services.

As regards integrity (in the context of the obligation on solicitors to act with integrity) the Court approved the definition of integrity offered in Solicitors Regulation Authority v Wingate [2018] 1 WLR 3969 in which the Court had, in turn, cited Hoodless with approval. The Court drew from Wingate the principle that *"in the context of the regulation of a profession there is an association between the notion of having integrity and adherence to the ethical standards of the profession."*

The Court further held that *"there is no free-standing legal notion of integrity in the manner of the received standard of dishonesty"*. Instead, the standard of conduct required by the obligation to act with integrity *"must be drawn from and informed by appropriate construction of the contents of the relevant rules"*, so as to facilitate a *"principled approach to the important point raised by the circumstances of this appeal: the extent to which it is legitimate for professional regulation to reach into personal lives of those who are regulated."*

The Court applied the same principle in relation to the obligation on solicitors to behave in a way that maintains the trust the public places in solicitors and in the provision of legal services. The content of the obligation had to be derived from and informed by appropriate construction of the relevant rules. There was a *"qualitative distinction"* between conduct that does or may tend to undermine public trust in the profession and *"conduct that would be generally regarded as wrong, inappropriate or even for the person concerned, disgraceful"*.

Applying this approach in the context of financial services, whether in the context of the Conduct Rules or the fit and proper test, means interpreting "integrity" and "reputation" in the context of the regulators' objectives and the provisions of the Handbook, including the examples and factors listed in COCON and FIT.

Each case will need to be considered on its facts but what is clear is that lack of integrity and reputation in this context does not mean failure to adhere to prevailing moral or ethical standards at large (to the extent that these can be determined), but failure to meet the standards of the profession, bearing in mind that the scope of the regulatory framework, as the Court said in Beckwith, *"cannot extend beyond what is necessary to regulate professional conduct and fitness to practise and maintain discipline within the profession."*

Culture and Psychological Safety

In assessing whether non-financial misconduct amounts to a breach of the Conduct Rules and/or impacts the fit and proper assessment, it is also important for firms to consider the FCA's wider perspective and to understand how the FCA links non-financial misconduct to its wider statutory objectives. Consistent with the judgment in Beckwith, this may impact on the interpretation of the scope of the Conduct Rules and the FIT assessment and it may also impact the firm's wider relationship with the regulator.

Pursuant to section 1B FSMA, the FCA's operational objectives include securing protection for consumers and protecting and enhancing the integrity of the UK financial system. In recent years, the FCA has placed increasing significance on the role of healthy and purposeful cultures in pursuing its operational objectives. In its 2020/2021 Business Plan, the FCA identified culture as one of its five key cross-sector priorities, noting: *"Firms' culture shapes the outcomes for consumers and markets, which is why [the FCA's] aim is to assess and address the drivers of culture."*

As Megan Butler explained in her letter to the Women and Equalities Commission, the FCA views non-financial misconduct as a potential symptom and/or cause of a poor culture, which in turn may drive other forms of misconduct or impact the FCA's statutory objectives:

"A culture where sexual harassment is tolerated is not one which would encourage people to speak up and be heard, or to challenge decisions. Tolerance of this sort of misconduct would be a clear example of a driver of poor culture."

Likewise, in the "Dear CEO" letter to insurance firms, the FCA identified non-financial misconduct and an unhealthy culture as a key root cause of harm:

"We view both lack of diversity and inclusion, and non-financial misconduct as obstacles to creating an environment in which it is safe to speak up, the best talent is retained, the best business choices are made, and the best risk decisions are taken."

The regulators' perspective is that if non-financial misconduct makes staff feel psychologically unsafe, that may prevent staff from working effectively more broadly, including, for example, by inhibiting staff from speaking up/offering an appropriate upward challenge. More broadly, it considers that tolerance of non-financial misconduct may serve to harm diversity (which, in turn, may hinder both innovation and firms' ability to meet the needs of consumers from diverse segments of society) and damage society's view of the financial services sector.

The effect of this perspective may be to draw within the regulator's remit conduct and behaviours that might otherwise appear to lack sufficient nexus with the workplace to be relevant to the regulatory regime.

Investigations and notifications under Principle 11/ Fundamental Rule 7

Where allegations of non-financial misconduct are made, firms will usually need to investigate in order to form a view on whether there has been a breach of the Conduct Rules or whether there is information relevant to the fit and proper assessment.

Firms will also need to investigate to assess whether their own internal standards and policies – which may go well beyond what is required by the regulatory system (and breach of which may itself be relevant to the fit and proper test) – have been breached.

In assessing what is necessary and proportionate by way of investigation firms may take account of the further guidance on the meaning of integrity set out above.

As regards notifications to regulators, Principle 11 and Fundamental Rule 7 require firms to notify the regulators of anything relating to the firm of which the regulators would reasonably expect notice.

In addition, SUP provides that if a firm becomes aware of information which would reasonably be material to the assessment of the fitness and propriety of a senior manager, it must inform the FCA within seven business days. This duty extends to any circumstances that would normally be declared when giving the information required for section 5 of Form A or matters considered in FIT, with section 5 of Form A requiring information on whether the individual has been the subject of an investigation into allegations of misconduct or malpractice in connection with any business activity, including an internal investigation by an authorised firm.

These are broad obligations applying to all of the firm's activities whether regulated or not, and firms will wish to ensure that they do not create additional risk by failing to notify or delaying doing so. As Megan Butler wrote in her letter to the Women and Equalities Committee: *"Firms must inform us promptly of potentially serious misconduct involving their employees, including criminal convictions and other sanctions, upheld complaints, and disciplinary proceedings."* And we know through our interactions with both regulated firms and the regulator that the FCA remains particularly focused on being notified of allegations of non-financial misconduct relating to senior managers. But firms are entitled to avoid taking an overly cautious approach under the guise of "zero tolerance" in a manner that could be counterproductive culturally – discouraging those who may have legitimate grievances from coming forward for fear of immediate notification to the regulator. A zero-tolerance approach might also result in excessive internal disciplinary action, which could increase employment law risk (particularly in the context of the FCA's regulatory reference regime). It is also noteworthy and relevant that Ms Butler referred to an expectation of being notified of serious misconduct involving employees.

Before notifying the regulator, firms are entitled to take a reasonable time to investigate the nature of allegations in order to establish whether the conduct alleged is sufficiently serious and sufficiently closely connected with the activities of the firm or the profession to justify further investigation and/or notification to the regulator.

Conclusion

Presently, as a result of the Covid-19 pandemic, many firms have shifted to homeworking, and this change looks likely to persist to some degree after the pandemic is over. This may not mean that the FCA's focus on non-financial misconduct will abate. The regulator will expect firms to take action to detect and prevent non-financial misconduct which may occur remotely or outside the office.

As Julia Hoggett, FCA Director of Market Oversight said in a speech on 12 October 2020 (albeit in relation to financial misconduct), *"staff should be in no doubt about the standards expected of them. And they should be in no doubt that these standards apply whether they are in the regular office, a disaster recovery site or at a makeshift workstation at home. Culture matters, and it matters most when the risks are highest."*

The FCA is also focused on whether firms and individuals are complying with the Covid-19 regulations and the government guidance. It was recently revealed that the FCA has received 47 whistleblower complaints relating to breaches of the Covid-19 regulations, including, for example, relating to miscategorising staff as individuals who have 'key worker' status and need to attend the office. Failure by individuals to comply with the Covid-19 regulations could be treated as relevant to the fit and proper assessment and might also impact on the FCA's view of a firm's culture and psychological safety.

In the wake of Beckwith, and subject to any appeal in that case, it may that both firms and the regulators are more cautious about treating non-financial misconduct as amounting to a breach of the Conduct Rules or as relevant to fitness and propriety.

But the regulator also expects firms to have in place appropriate systems and controls, including to evaluate whether or not non-financial misconduct impacts on the Conduct Rules or fitness and propriety. In other words, there is an obligation on firms to be considering issues relating to non-financial misconduct in the right way, where it has the potential to fall within the regulator's remit, regardless of whether it ultimately does. Failures in such systems and controls were always likely to be a greater area of risk for firms than the underlying misconduct itself, and that has not changed.

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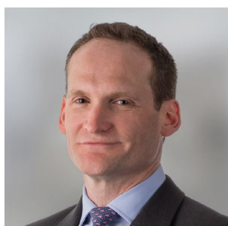

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