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NON-FINANCIAL MISCONDUCT IN FINANCIAL SERVICES REGULATION

WHERE DO WE STAND?

FEBRUARY 2024

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

In this updated briefing, we consider the current approach of the Financial Conduct Authority ("FCA") to non-financial misconduct, the scope of its authority to take action, the potential impact of its recent proposals – and governance steps to handle the ongoing regulatory survey.

In recent years, the FCA has emphasised that non-financial misconduct falls within its regulatory remit and has prohibited several individuals convicted of serious offences from working in financial services. However, the absence of explicit regulatory guidance, as well as some apparent inconsistencies in regulatory decisions have led to some uncertainty as to the scope of the FCA's authority.

In September 2023, the FCA and the Prudential Regulation Authority ("PRA") published consultation papers (FCA CP23/20 and PRA CP 18/23, each a "Consultation Paper") on a package of measures to promote diversity and inclusion in the financial services sector, including proposed amendments to specify where the Regulators' rules apply to non-financial misconduct. The FCA is also seeking data from firms across the sector about how non-financial misconduct is dealt with.

Key issues

What has been the FCA's stance to date?

In September 2018, following the rise of the *"#metoo"* movement and the subsequent publication of the Women and Equalities Committee's report on sexual harassment in the workplace, Megan Butler, then the FCA's Executive Director of Supervision (Investment, Wholesale and Specialists Division), wrote a well-publicised letter which expressed that the FCA sees sexual misconduct as falling within the scope of the financial services regulatory framework. She noted that it did so in three key ways:

1. through supervision of workplace culture;
2. through fitness and propriety assessments (in respect of employees performing certification or senior management functions); and
3. potentially, through the Conduct Rules (in respect of all staff except ancillary personnel).

The FCA has since reiterated on several occasions that non-financial misconduct falls within its remit. For example, in a December 2018 speech, Christopher Woolard, Executive Director of Strategy and Competition at the FCA, summarised the FCA's position as "*non-financial misconduct is misconduct, plain and simple*" and, in January 2020, the FCA sent a "Dear CEO" letter to insurance firms, setting out that non-financial misconduct was a "*key root cause of harm*". More recently, during the Treasury Select Committee inquiry "Sexism in the City", the FCA discussed its proposals for tackling non-financial misconduct, and recognised that whilst this is a societal issue, it is also a financial services issue. Sarah Pritchard, Executive Director of Markets and International, observed that a high volume of notifications to the FCA for non-financial misconduct by a firm could be interpreted as a sign of a healthy culture where conduct is not left unchallenged.

The FCA announced in January 2024 that it would be commencing a survey of wholesale banks and wholesale insurers on certain data regarding non-financial misconduct. It wrote to insurers on 6 February 2024. The FCA proposes to roll this out across the sector, having commenced with wholesale insurance firms and intermediaries.

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The FCA has also indicated that the Senior Managers and Certification Regime ("SMCR") is intended to be a key tool in addressing non-financial misconduct as well as cultural issues. The 2020 "Dear CEO" letter to insurance firms, for example, set out that tackling non-financial misconduct would be a key focus for the FCA in its supervision of senior managers, and specifically that "*a senior manager's failure to take reasonable steps to address non-financial misconduct could lead [the FCA] to determine that they are not fit and proper".* Likewise, in July 2021, the Regulators' "Discussion Paper on Diversity and Inclusion in the Financial Services Sector" (DP 21/2) stated: *"... we have been taking increasing steps to enhance diversity and inclusion, for example through a more assertive supervisory focus on non-financial misconduct under the Senior Managers and Certification Regime".*

Illustrating its commitment to tackling non-financial misconduct in practice, the FCA has taken action against several individuals:

- On 5 November 2020, the FCA announced that it had prohibited three individuals – Russell Jameson, Mark Horsey and Frank Cochran – from working in financial services on the basis of convictions for sexual offences. In announcing those prohibitions Mark Steward, then 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."*
- In March 2021, the FCA announced that it intended to prohibit another approved person, Jon Frensham, who had been convicted of attempting to meet a child following sexual grooming. The FCA determined that Mr Frensham was not a fit and proper person to perform any function in relation to any regulated activity because he lacked the necessary integrity and reputation. Mr Frensham referred the FCA's decision to the Upper Tribunal, which subsequently upheld the FCA's prohibition order. In doing so, however, the Upper Tribunal was critical of the FCA's approach (as discussed below).
- In November 2022, the FCA issued a final decision notice against Ashkan Zahedian prohibiting him from performing any regulated activity. In this instance, Mr Zahedian had been convicted of causing grievous bodily harm, which the FCA considered demonstrated a *"clear and serious lack of integrity and reputation such that he is not fit and proper to perform regulated activities."*

In July 2023, in a letter to Harriett Baldwin MP, the Chair of the Treasury Select Committee, Nikhil Rathi, the FCA's Chief Executive, confirmed that the FCA had been investigating Crispin Odey and the asset management firm he founded, Odey Asset Management LLP ("OAM") (collectively, the "Odey Investigation"), including in relation to Mr Odey's personal conduct. In that letter, Mr Rathi commented on the Regulator's approach to non-financial misconduct more generally, reiterating that the FCA *"remains focused on improving the culture of the firms it regulates",* and that *"a corporate culture that tolerates sexual harassment or other non-financial misconduct is unlikely to be one in which people feel able to speak up and challenge decisions, or one in which they will have faith that concerns will be independently and fairly assessed".* Mr Rathi noted that the *"vast majority"* of regulated firms understand that the FCA considers non-financial conduct to be *"relevant to assessments of fitness and propriety"* and can also amount to a breach of the conduct rules.

Similar sentiments were also expressed on 8 September 2023 in a "Dear CEO" letter to the wholesale banking sector, which identified that non-financial misconduct was one of the FCA's key priorities for the sector, and noted that a corporate culture which tolerates sexual harassment or other non-financial misconduct *"raises questions about a firm's decision-making and risk management".*

As noted above, the FCA and PRA Consultation Papers published in September 2023 include proposed amendments to the Regulators' rules to specify where they apply to non-financial misconduct. Specifically, the FCA proposes to make amendments to its Handbook to explicitly address non-financial misconduct within the Conduct Rules, Fit and Proper assessments, and Suitability guidance on the Threshold Conditions.

Similarly, the PRA proposes to update SS35/15 (Strengthening individual accountability in insurance) and SS28/15 (Strengthening individual accountability in banking) to clarify that the PRA may take into consideration established patterns of behaviour when assessing fitness and propriety. The consultation closed on 18 December 2023, with Policy Statements anticipated in H2 2024, and the new rules would be expected to come into force 12 months from that date.

The FCA stated in its information gathering letter on 6 February 2024 that: "*Our publicly expressed view sets out that non-financial misconduct is misconduct and not an additional principle. Non-financial misconduct includes individuals' conduct for issues such as (but not limited to) bullying, sexual harassment, and discrimination whether in or outside the workplace."*

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During evidence to the recent Treasury Select Committee inquiry, "Sexism in the City", Sarah Pritchard had explained that the FCA is "*commencing a survey of wholesale banks and wholesale insurers, to look at numbers and statistics of non-financial misconduct cases in that part of financial services, methods of detection and methods of resolution".* This will be rolled out across the sector. The FCA will use its findings to baseline firms and to inform its supervisory approach to the new rules. In addition, this work and, in particular, the focus on methods of resolution, will also enable the FCA to better understand the use of NDAs in cases of alleged non-financial misconduct. Sarah Pritchard also explained that the future proposals will make clear that *"where disciplinary action is taken for non-financial misconduct, firms are obliged to report that to"* the FCA, regardless of the existence of an NDA. Firms need good governance in place to ensure the appropriateness, completeness and accuracy of the responses.

The FCA's grounds for addressing non-financial misconduct

The FCA's cases to date have tended to centre on whether regulated individuals who have been convicted of sexual or violent offences are fit and proper, and fitness and propriety is likely to continue to be the main basis on which the FCA addresses non-financial misconduct.

However, as noted in both Ms Butler's and Mr Rathi's committee evidence, and made clear in the FCA's Consultation Paper, the FCA may also be able to take action to address a breach of the Conduct Rules or as part of its supervision of firm culture. Further, the Odey Investigation indicates that the FCA may investigate firms for systems and controls failings. Consequently, where allegations of non-financial misconduct arise, firms must assess the various grounds for action and risks of regulatory action. These are considered further below, along with details of changes proposed by the Regulators in the Consultation Papers.

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, such as the obligation to act with integrity (Rule 1).

When might non-financial misconduct be a breach of Conduct Rules?

The Code of Conduct rules ("COCON") section of the handbook includes a non-exhaustive list of examples of conduct that would be in breach of the Conduct Rules, although it does not currently make any specific reference to non-financial misconduct (one of the biggest changes proposed in the FCA's Consultation Paper is that that reference will now be included). The current list includes various examples of dishonest or misleading conduct in the course of providing financial services, including misleading clients, the Regulators and others in the firm.

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. Even for banks, however, where the Conduct Rules apply to any of the firm's activities whether regulated or not, they apply only in relation to the performance of functions relating to the firm's activities. It follows that for non-financial misconduct to constitute a breach of the Conduct Rules, 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. Therefore, the circumstances in which non-financial misconduct may be within the scope of the Conduct Rules may be limited. This should be considered by firms on a case-by-case basis.

What changes to the Conduct Rules are proposed?

The FCA proposes changes to COCON to clarify that the Conduct Rules cover serious instances of bullying, harassment and similar behaviours towards fellow employees and employees of group companies and contractors.

The proposed amendments to COCON include examples of non-financial conduct that may breach COCON. Some of these examples, such as *"seriously offensive, malicious, or insulting conduct"* and *"unreasonable and oppressive conduct causing serious alarm or distress to a fellow member of the workforce"* are relatively general in nature and may bring a wide range of behaviours into the scope of these rules.

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FCA Information request regarding non-financial misconduct: responding

The FCA is performing a sector-wide information gathering exercise regarding non-financial misconduct (commencing with insurers). Although the FCA explains the survey does not seek detailed information regarding specific cases, per the initial letter to the insurance sector on 6 February 2024 it seeks three years of data covering:

- The number of non-financial misconduct incidents recorded (by type/category) and the method by which these incidents were detected (e.g., whistleblowing and surveillance within firm);
- The number of non-financial misconduct incidents recorded (by type/category of incident e.g., sexual harassment, bullying, and discrimination) and the outcomes of those incidents (e.g., dismissal, written warning, and complaint not upheld);
- The number of further outcomes recorded (e.g., non-disclosure agreements and employment tribunals).

And that these statistics:

- be distinguished between SMF (Senior Management Function) and non-SMF;
- include all incidents, including those that firms have not already reported to the FCA (e.g., the incident did not meet FCA reporting thresholds).

The letter explained the survey also includes high level questions on:

- Regulatory references;
- Governance and management information;
- Appointed Representatives;
- Diversity and inclusion policies;
- Remuneration, disciplinary and whistleblowing policies and procedures.

We expect the FCA to use this information to benchmark firms and to decide where to focus future supervisory attention.

On the face of the matter some these may seem like straightforward questions to answer, but firms will need to:

- Consider carefully the scope of the letter and survey that they receive;
- Navigate privilege and understand how their responses may be viewed by the regulator;
- Establish what the relevant data set will include (including how to identify incidents, what constitutes an incident, what amounts to senior manager involvement);
- Ensure they can obtain the relevant data in the timeframe and how it will be verified;
- Whether and when to provide additional context with answers;
- Establish who will co-ordinate responding.

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The FCA makes clear, however, that the proposed expansion does not cover non-financial misconduct in a person's private or personal life and has made efforts to provide guidance on when a person's conduct is or is not outside the COCON rules (including with a table setting out whether particular examples of conduct are generally within the scope of COCON). For example, misconduct by a Conduct Rule staff member in relation to a fellow member of the workforce at a social occasion organised by their firm would be in scope, but misconduct in relation to a fellow member of the workforce at a social occasion organised by them in their personal capacity would not be in scope. The distinction - also made in the regulatory survey - between events organised in a personal capacity and work events may well be difficult to draw in some cases (particularly where this interacts with employment law and vicarious liability considerations) and presents challenges for firms seeking to investigate potential breach incidents.

Fit and Proper Assessment

As indicated by the recent FCA prohibitions, allegations of non-financial misconduct may 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?

Fitness and propriety is assessed by reference to honesty, integrity and reputation; competence and capability; and financial soundness. The FCA treats non-financial misconduct as potentially relevant to honesty, integrity and reputation and, in some cases, competence and capability.

The current version of 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 the Fit and Proper test for Employees and Senior Personnel ("FIT") should consider all relevant matters, including those set out in the FIT section of the FCA Handbook, 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 member of staff 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. Currently, there is no express reference to non-financial misconduct (again, a key change under the FCA Consultation Paper would be to make such references).

In accordance with FIT, firms must ensure that individuals performing a senior management function or a certification function are fit and proper to carry out their role, and FIT provides guidance on how firms should make that assessment. As the FCA set out in its "Dear CEO" letter to insurance firms in 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.

What changes to FIT are proposed?

The FCA's proposed guidance details how non-financial misconduct forms part of the fit and proper test.

1. As regards competence and capability, the guidance in the FCA Handbook provides that the FCA would expect an SMCR firm determining the 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.

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The amendments explicitly confirm that misconduct in a person's personal or private life may be relevant to an assessment of fitness and propriety, even where it does not involve a breach of standards that are equivalent to those required under the regulatory system and/or there is little or no risk of that behaviour being repeated in their work for their firm. The FCA indicates that this will be the case if the individual's behaviour is *"disgraceful or morally reprehensible or otherwise sufficiently serious"*.

The proposals regarding fitness and propriety are intended to clarify that conduct which could damage public confidence in the UK's financial system is not compatible with the FCA's statutory objectives and, is likely to mean that the relevant individual is not fit and proper. The FCA considers that providing this guidance will reduce the risk of inconsistency in how FIT is interpreted and applied in firms and within judicial settings.

Notwithstanding the FCA's efforts to provide clarity through the introduction of greater guidance on non-financial misconduct, the proposed amendments may raise questions and leave room for interpretation. For example, firms may query the extent to which they will be required to actively explore individual conduct outside the workplace in respect of fit and proper assessments and, if it is assumed that firms will not be expected to proactively investigate employees' private lives unless on notice of an issue, the question arises as to what amounts to being *"on notice"*.

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. This may impact on the interpretation of the scope of the Conduct Rules and the FIT assessment, and 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 (the "consumer protection objective") and protecting and enhancing the integrity of the UK financial system (the "integrity objective"). SUP 1A.3.2A of the FCA Handbook explains that in its supervisory approach, the FCA will have a focus on culture and governance.

In recent years, the FCA has placed increasing significance on the role of healthy and purposeful cultures in pursuing its operational objectives. 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 Regulator's 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 appropriate upward challenges. More broadly, it considers that tolerance of non-financial misconduct (including harassment and bullying) may serve to harm diversity and inclusion, and foster groupthink (and that this, in turn, would damage society's view of the financial services sector, protection for consumers, and the UK's competitiveness and economic growth).

In the recent Consultation Papers, the Regulators have sought to further clarify the importance of culture in tackling non-financial misconduct and improving diversity. For example, in its Consultation Paper, the FCA explains that one of its desired outcomes is a healthy culture in firms and notes that *"Non-financial misconduct erodes psychological safety and trust and can also increase the risk of groupthink and the problems that gives rise to."*

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Systems and controls

The FCA expects firms to manage the risks associated with non-financial misconduct and poor culture through the implementation of effective governance and controls. For example, in a speech on 28 November 2022, Emily Shepperd, FCA COO and Executive Director of Authorisations, said: *"The FCA expects senior leaders to nurture healthy cultures in the firms they lead. Cultures that are purposeful. That have sound controls and good governance."* In her more recent speech on 23 November 2023, Emily Shepperd spoke of the importance of transparency in enabling good governance, and for this to *"run all the way through to the top"*, so that *"boards… have the information they need to set cultural and strategic direction"*. These expectations are highlighted by the Odey Investigation which includes investigating whether OAM contravened the FCA's Principles for Business by failing to conduct its affairs with due skill, care and diligence, and/or failing to take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems and controls. In conducting its investigation, the FCA is specifically considering whether contraventions occurred because OAM failed to have a compliant governance structure.

In his July 2023 letter to the Treasury Select Committee, Mr Rathi stated: *"We expect firms to have effective systems in place to identify and mitigate risks of all kinds. Should allegations or evidence of non-financial misconduct come to light we expect a regulated firm to take them seriously through appropriate internal procedures. We can investigate and act against authorised firms that fail in this regard for inadequate systems and controls."*

Firms must therefore ensure that internal controls are appropriate to tackle the risk of non-financial misconduct, both in terms of preventing poor conduct occurring and ensuring that any issues that do arise are addressed effectively.

Understanding Integrity

As the analysis above indicates, a lack of integrity is a key driver in terms of the FCA taking action to address non-financial misconduct. It is therefore key to understanding the meaning of integrity to identify where non-financial behaviour amounts to a lack of integrity that the FCA might seek to address.

The current version of the FCA Handbook provides no specific guidance on what non-financial misconduct might amount to a lack of integrity, as the list of examples that would be in breach of the requirement to act with integrity in COCON does not include non-financial misconduct. Likewise, the factors listed in FIT for assessing integrity focus only on financial misconduct. These examples are not exhaustive, however, and do not exclude the possibility of non-financial misconduct constituting a lack of integrity or reputation.

The correct legal approach to integrity has been considered on several occasions by the courts and professional tribunals, as well as by the FCA and the Upper Tribunal:

Hoodless and Blackwell

In the well-known case of Hoodless and Blackwell v FSA [2003], 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."*

Wingate

In Solicitors Regulation Authority v Wingate [2018] 1 WLR 3969, the Court of Appeal specifically considered the standard of conduct expected of a professional person (in that case, a solicitor) acting with integrity. Referring to the Hoodless definition, the Court held: *"Integrity connotes adherence to the ethical standards of one's own profession […] Obviously, neither courts nor professional tribunals must set unrealistically high standards ….]. The duty of integrity does not require professional people to be paragons of virtue. In every instance, professional integrity is linked to the manner in which that particular profession professes to serve the public."*

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Beckwith

In Beckwith v SRA [2020] EWHC 3231 (Admin), the Administrative Court approved the definition of integrity offered in Wingate, drawing from 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".*

Frensham

In the Frensham case, the Upper Tribunal applied the principles set out in Wingate and Beckwith to those involved in regulated financial services. The Upper Tribunal agreed that, since Mr Frensham had been convicted of a criminal offence concerning a child, his personal reputation had clearly been severely damaged. However, to justify regulatory action in circumstances where the relevant behaviour occurred in his private rather than professional life, Mr Frensham's actions must have engaged the standards of behaviour required of the individual concerned by the applicable regulatory provisions. In other words, in such circumstances, a distinction has to be drawn between personal integrity and professional integrity, and the Regulator must determine whether in all the circumstances, the failings of personal integrity also amount to failings of professional integrity.

The Upper Tribunal considered that, in relation to the FCA's regulatory framework, the starting point must be its statutory objectives, including the consumer protection objective and the integrity objective. Therefore, "*in deciding whether to make a prohibition order a key consideration is the severity of the risk which the individual poses to consumers and to confidence in the financial system, thus providing a direct link to the statutory objectives".* In upholding the FCA's decision, the Upper Tribunal was satisfied that it was reasonably open for the Regulator to establish a link between Mr Frensham's offences and the integrity objective. The Upper Tribunal did not consider that the FCA would have been able to make this decision based solely on the fact of Mr Frensham's conviction, but it was reasonably open to the Regulator when taking into account:

- the circumstances in which the offence came to be committed (including the fact Mr Frensham was on bail for another suspected offence when he committed the offence) and
- Mr Frensham's failure to be open and cooperative with the Regulator in a number of different respects.

The Tribunal's conclusion relied heavily on the fact that Mr Frensham had breached his bail conditions and had failed to be open and transparent with the FCA, rather than on the fact of his criminal conviction.

Although Mr Frensham's reference to the Upper Tribunal was dismissed, the Upper Tribunal made criticisms of the FCA's case. The Tribunal found the manner in which the FCA sought to link Mr Frensham's offence to his professional role on the basis of the nature of the offence alone to be "*speculative and unconvincing"*, and that it had made bare assertions without evidence to support them. Consequently, it found the Regulator failed to clearly link the facts of the case to the relevant regulatory provisions.

The Upper Tribunal suggested that it would have been helpful had the FCA's assertions been backed up by criminological or psychological evidence which could support the view that the serious offence Mr Frensham committed created *"a significant risk that he would likewise seek to exploit vulnerable clients (such as the elderly) who seek to rely on him".* The Tribunal found it unhelpful to the FCA's case that Mr Frensham had continued to work since his offending, apparently without incident and that the FCA had not taken action sooner.

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Zahedian

In the Zahedian case, the FCA acknowledged that the trial judge had observed that the offences were out of character and were unlikely to ever be repeated. Mr Zahedian had pleaded guilty, expressed genuine remorse, and was open and cooperative in relation to the criminal proceedings. The FCA, however, took the view that the violent nature of his offences showed *"deliberate and criminal disregard for appropriate standards of behaviour"*, which reflected on his character. In other words, Mr Zahedian demonstrated a clear and serious lack of integrity. Further, the FCA considered that the associated publicity following his conviction meant that Mr Zahedian did not have the requisite reputation to perform functions in relation to regulated activities and posed a risk to the reputation of any future firm (plus potentially the financial services sector itself). Accordingly, he was not fit and proper to perform regulated activities.

The FCA's focus on Mr Zahedian's personal character may potentially be seen to be inconsistent with the position taken by the Upper Tribunal in the Frensham case, which held that the FCA must assess whether the failings of personal integrity also amount to failings of professional integrity. However, the FCA did not acknowledge this difference in the decision and, given that Mr Zahedian did not escalate the case to the Upper Tribunal, the Upper Tribunal has not opined on this approach.

In May 2023, the FCA made findings (including by reference to integrity), in respect of the former CEO of Barclays Jes Staley (although no adverse findings were made against the firm). The findings related to the accuracy of correspondence with the FCA, rather than what might be categorised as any non-financial misconduct *per se* (and, more generally, it can be easier for the FCA to approach non-financial misconduct indirectly).

Proposed clarifications

The FCA's proposed amendments to FIT in its Consultation Paper seek to address some of the perceived inconsistencies that have arisen due to apparent differing views between the FCA and Upper Tribunal as to the necessary link between personal and professional integrity. As expressed in its Consultation Paper: *"We consider that articulating our views clearly in FIT would reduce the risk of inconsistency in how our guidance on non-financial misconduct is interpreted and applied in firms and within judicial settings."*

As noted above, under the proposed amendments to the rules: *"misconduct in a person's private or personal life or in their working life outside the regulatory system may be relevant to their fitness and propriety even though it does not involve a breach of standards that are equivalent to those required under the regulatory system. In particular it may show that the person lacks moral soundness, rectitude and steady adherence to an ethical code. That in turn raises doubts as to whether they will follow the requirements of the regulatory system."* The proposed rules also clarify that *"disgraceful or morally reprehensible or otherwise sufficiently serious"* may be relevant to fitness and propriety even if it does not damage public confidence in the financial system and/or there is little or no risk of it being repeated in the individual's work for their firm. It remains to be seen whether these amendments will be introduced and, if so, how they will be applied by the FCA in practice.

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Enforcement of non-financial misconduct – looking ahead

As described in this briefing, the FCA has drawn its regulatory perimeter to allow it to sanction non-financial misconduct, with implications for both firms and individuals.

Whilst enforcement action against individuals for non-financial misconduct is rare, the recent FCA cases have highlighted the Regulator's willingness to hold individuals to account where serious misconduct has been committed, even where that conduct is unrelated to regulated activities. To the extent amendments to the rules are introduced, the FCA is likely to consider this to be a firmer basis on which to enforce the standards that they consider are already within their remit. Therefore, given the existing focus on this area and recent enforcement action by the FCA, there may be an increase in the number of investigations relating to non-financial misconduct opened by the FCA.

Non-financial misconduct cases have, to date, focused on the fitness and propriety of regulated individuals and, as noted above, this is likely to continue to be the main basis on which the FCA seeks to address non-financial misconduct. However, if the proposed amendments are introduced, the FCA may view the Conduct Rules as a more feasible option in relation to workplace misconduct such as bullying or harassment. In this context, it is noted that a broader range of employees are subject to the Conduct Rules than to FIT although, in practice, the FCA are likely to focus their regulatory attention on more senior individuals, unless the misconduct in question is particularly serious.

Further, it is anticipated that the introduction of amended rules may give rise to further cases like Zahedian where the FCA does not draw a direct link between an individual's personal conduct and their professional integrity. Under the proposed rules, in such cases the FCA may be able to rely on the fact the underlying behaviour is considered to be very serious or morally reprehensible. Amended rules may also enable the FCA to take action against individuals where there has not been a conviction of a criminal offence.

Beyond individuals who have committed non-financial misconduct, it is feasible that, in the future, the FCA might also take action against senior managers who fail to take steps to ensure good conduct and culture within their areas of responsibility.

Firms meanwhile must remain mindful that in investigating workplace-related non-financial conduct, the Regulators may scrutinise the adequacy of the firm's systems and controls. To manage this risk, firms should implement and maintain adequate measures that set out clear expectations in relation to employees' non-financial conduct (and provide training where needed), and which ensure that issues are effectively investigated, addressed and, where necessary, reported should they arise.

Firms are, of course, expected to take their own steps to investigate and sanction non-financial misconduct where needed, including via disciplinary action and correct use of regulatory references. In investigating potential instances of non-financial misconduct, firms must take heed to the FCA's Principle 11 and the PRA's Fundamental Rule 7, which require firms to notify the Regulators of anything relating to the firm of which the Regulators would reasonably expect notice, as well as to SUP 10C.14.18 which provides that if the 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. 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."* Before notifying the Regulators, however, firms are entitled to take a reasonable time to investigate the nature of allegations in order to establish whether the conduct alleged is both sufficiently serious and closely connected with the activities of the firm or the profession to justify further investigation and/or notification to the Regulator. This expectation that firms must take proactive action in relation to non-financial misconduct is reinforced in the FCA's Consultation Paper, which states: *"our aim is to give firms the reassurance needed to take decisive action against employees for instances of non-financial misconduct."* It is noted that, under the proposed amendments, failure to take action to address non-financial misconduct could impact a firm's ability to meet its threshold conditions where the firm is connected with individuals who have been convicted of certain types of non-financial misconduct (including violence, sexual offences and offences relating to a person's or a group's demographic characteristics).

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

Conclusion

Non-financial misconduct continues to be an area of regulatory focus and development, with further updates anticipated. It is therefore important that both firms and individuals understand (and continue to track) the Regulators' expectations in relation to non-financial conduct, both in and outside of work, and take necessary steps to mitigate risk. For firms, in particular, that means having in place appropriate systems and controls, including to evaluate whether or not the specific non-financial misconduct impacts on the Conduct Rules or fitness and propriety. Ultimately, failing to engage properly with the potential risks presented by non-financial misconduct may lead to regulatory investigation and significant sanctions. Following its ongoing regulatory survey, the FCA will likely have a considerable amount of data to inform its approach – which will hopefully lead to increased certainty.

Further reading

Clifford Chance briefing on FCA CP23/20 and PRA CP 18/23, available here:
https://www.cliffordchance.com/briefings/2023/10/fca-and-pra-consultation-on-diversity-and-inclusion-in-the-financial-services-sector.html

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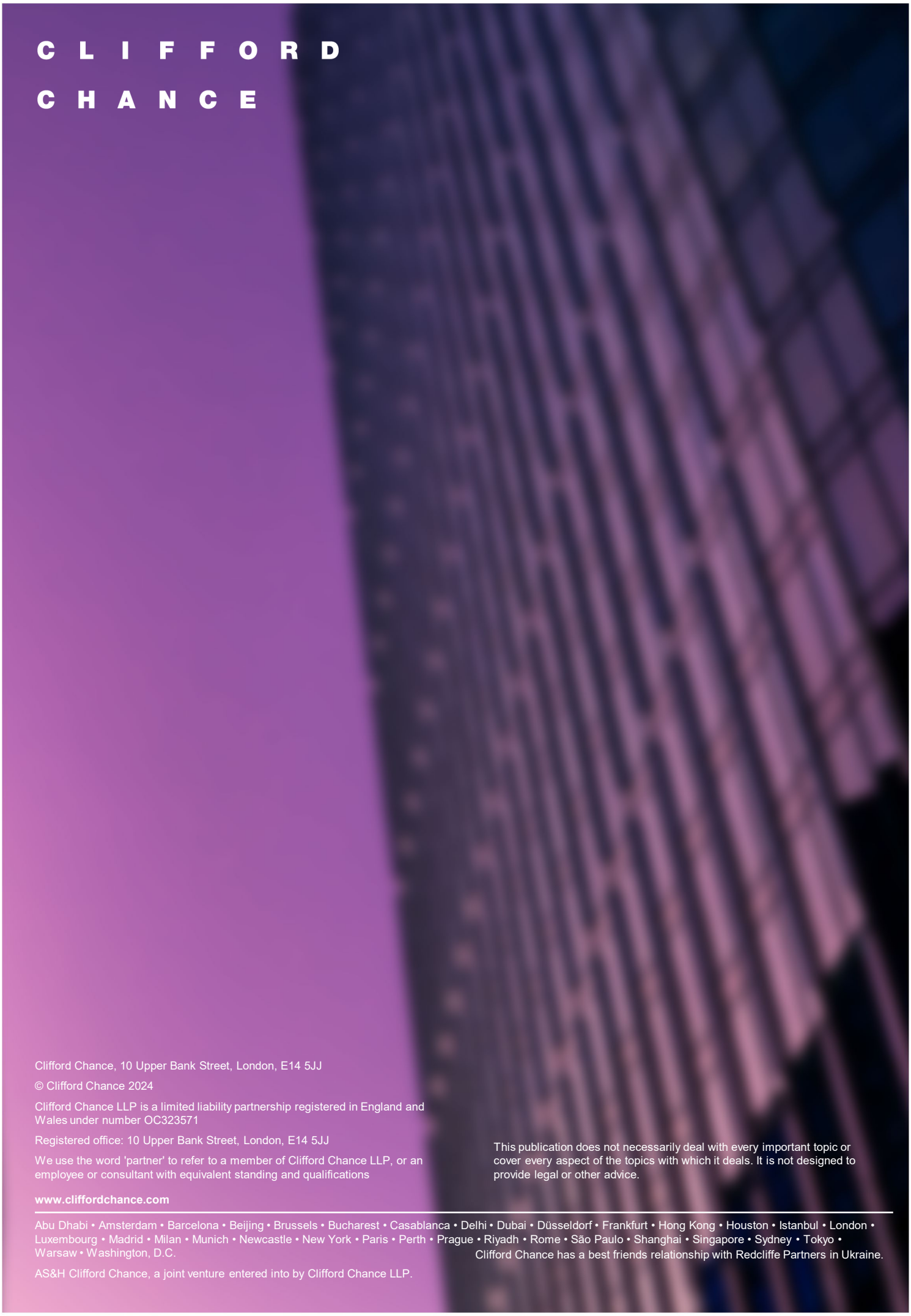
1. AS&H Clifford Chance, a joint venture entered into by Clifford Chance LLP.
2. Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.



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