

THE CHALLENGE OF ADDRESSING NON-FINANCIAL MISCONDUCT IN UK REGULATED FIRMS

To Our Clients and Friends:

Many UK regulated firms will be currently (re-)assessing staff as fit and proper and training staff on the FCA's (or the PRA's) Conduct Rules. The FCA has recently banned three individuals from working in the financial services industry for non-financial misconduct outside the workplace. The enforcement actions are, therefore, a timely reminder for regulated firms that the FCA has indicated it will bring an increased focus on how firms deal with non-financial misconduct by employees, both within and outside of the workplace.

Although these three specific cases followed criminal prosecutions for serious sexual offences, regulated firms are faced with particular challenges in determining how to deal with staff issues where the activities are not of the same degree of seriousness, take place outside of the workplace and are unconnected to any regulated activity undertaken by an individual.

Firms should consider what types of employee behaviour within and outside the workplace might be considered non-financial misconduct rendering an individual no longer "fit and proper" or alternatively constitute a breach of the FCA's (or PRA's) Conduct Rules reportable to the relevant regulator. Firms would be advised to appropriately document this assessment and consider how this is communicated to staff.

What enforcement action has the FCA taken ?

- **Russell David Jameson**^[1] - Jameson was a financial adviser at an authorised firm and was approved by the FCA to hold various significant influence and customer facing functions. In July 2018, he was convicted of serious criminal offences involving the making, possession and distribution of indecent images of children and 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.
- **Mark Horsey**^[2] - Horsey was the sole director and shareholder of an authorised financial advice firm. Horsey had surreptitiously observed and video recorded his tenant having a shower without their consent. Horsey 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.

- **Frank Cochran**^[3] - Cochran was a director and shareholder of an authorised financial advice firm. In April 2018, he was convicted of sexual assault, engaging in controlling and coercive behaviour and an offence contrary to the Protection from Harassment Act 1997. Cochran was sentenced to seven years' imprisonment and required to sign the sex offenders register.

These individuals committed the offences whilst they were FCA approved persons. The FCA found that all three were not fit and proper and lacked the necessary integrity and reputation required to work in the regulated financial services sector.

What are the FCA's expectations as to how firms address non-financial misconduct?

In response to the recent Final Notices, Mark Steward, FCA Executive Director of Enforcement and Market Oversight, stated that: "*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.*"^[4] This indicates that the regulatory direction of travel is an increased focus on how firms address instances of non-financial misconduct. This is supported by other important FCA announcements on this topic.

In September 2018, Megan Butler, FCA Executive Director sent a letter to House of Commons' Women and Equalities Committee.^[5] The letter addressed the important issue of sexual harassment and noted that the FCA regarded it as misconduct that falls within the scope of the FCA's regulatory framework. Tolerance of this sort of misconduct would be a clear example of a driver of poor culture. Megan Butler noted that sexual harassment and other forms of non-financial misconduct can amount to a breach of the FCA's Conduct Rules and the Senior Managers and Certification Regime ("SMCR") imposes requirements on firms to notify the FCA of Conduct Rule breaches. The letter was followed by a speech in December 2018 by Christopher Woolard, FCA Executive Director of Strategy and Competition.^[6] Mr Woolard noted that "the way firms handle non-financial misconduct, including allegations of sexual misconduct, is potentially relevant to our assessment of that firm, in the same way that their handling of insider dealing, market manipulation or any other misconduct is."

In January 2020 a "Dear CEO" letter^[7] from Jonathan Davidson, FCA Executive Director of Supervision, Retail and Authorisations, was published regarding non-financial misconduct. Although the letter was addressed to the wholesale general insurance sector, it is indicative of the FCA's approach to non-financial misconduct across the regulated sector. In particular, Mr Davidson noted that non-financial misconduct and an unhealthy culture is a key root cause of harm. How a firm handles non-financial misconduct throughout the organisation, including discrimination, harassment, victimisation and bullying, is regarded as being indicative of a firm's culture. The FCA expects firms, and senior managers to embed healthy cultures by identifying and modifying the key drivers of their culture. Mr Davidson highlighted that the FCA's Approach to Supervision document flags the 4 key drivers of culture. These drivers are: leadership; purpose; approach to rewarding and managing people; and governance, systems and controls.

What challenges do firms face relating to non-financial misconduct?

Where the actions of individuals result in convictions and custodial sentences the decision on the fit and proper test is often (but not always) straightforward and the enforcement actions above, together with the various FCA pronouncements also identified, make clear the FCA's view in this area.

However, regulated firms can be faced with a number of challenges when assessing non-financial misconduct, particularly when it occurs outside of the workplace.

(1) Identifying non-financial misconduct

It is often difficult for firms to identify non-financial misconduct, particularly if it occurs outside of the office. This may be a result of employees incorrectly understanding a firm's policies and procedures around what must be brought to the firm's attention or a reluctance of staff to reveal such matters to the firm.

Firms are expected to be able to demonstrate to the FCA that they have that the right processes in place to handle and escalate such cases appropriately. At a time when many employees are working from home the challenge for firms is greater. Firms should ensure that:

- staff are trained and have an understanding of their obligations to inform the firm of relevant matters;
- guidance for staff is clear on the types of matters about which firms would expect to be notified; and
- such guidance should include examples of non-financial misconduct, and the guidance and training should be appropriately documented.

(2) Determining which matters need (immediate) escalation to the FCA

Principle 11 of the FCA's Principles for Business requires a firm to maintain an open and cooperative relationship with regulators, as well as disclosing appropriately anything relating to the firm of which the FCA would reasonably expect to be notified. Senior Managers are also subject to a Senior Manager Conduct Rule and must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

Not all instances of misconduct would, however, require an immediate notification – firms will have a challenge in determining whether a matter is sufficiently material to warrant disclosure to a regulator. Factors to consider include:

- seniority or significance of the individual to the firm; and
- seriousness of conduct, potentially as represented by outcome.

(3) Undertaking “fit and proper” assessments

The recent enforcement actions all involved an assessment of the individual concerned under the FCA’s Fit and Proper Test for Employees and Senior Personnel. The most important considerations when assessing the fitness and propriety of a person are the person’s: (1) honesty, integrity and reputation; (2) competence and capability; and (3) financial soundness. Conviction for a serious sexual offence will clearly cause an individual to fail the test. The challenge for firms comes when the scenario is less clear cut. The concepts of “honesty” and “integrity” are inherently subjective and result in a regulated firm often having to make a difficult judgement in a given scenario.

(4) Interplay with the SMCR

The introduction of the SMCR marked a regulatory shift from collective responsibility to individual accountability. For staff subject to the FCA’s Conduct Rules, in addition to the fit and proper test, firms must also make an assessment as to whether any misconduct constitutes a breach of the Conduct Rules. The Conduct Rules are drafted to cover the activities of in-scope staff in both the regulated and unregulated parts of a business. The difficulty arises for firms in assessing when non-financial misconduct, particularly outside of the workplace, also amounts to a breach of the Conduct Rules.

This is important as firms are required to report any disciplinary action taken against an individual for a breach of the Conduct Rules. Firms are also required to include Conduct Rule breaches in regulatory references from new employers once staff have left the firm. It is, therefore, important that firms have a robust process in place for determining what types of employee behaviour within and outside the workplace might be considered a breach of the Conduct Rules and that all such decisions are clearly documented.

What practical steps can firms take to meet regulatory expectations?

It is clear that there is increasing regulatory focus on how regulated firms deal with non-financial misconduct and that failure to tackle such issues appropriately can be taken by the FCA as an indicator of poor culture. Firms would be advised to undertake an assessment as to how they in practice deal, or would deal, with instances of non-financial misconduct by staff.

The following practical steps are examples of matters that firms should consider to ensure that they meet regulatory expectations in this area.

- Fitness and propriety assessments of incoming and existing staff should consider a broad spectrum of indicators, including data around financial and non-financial conduct, inside and outside the workplace.
- Firms should proactively consider the types of non-financial misconduct that would trigger a fitness and propriety re-assessment and, as applicable, a review of whether a Conduct Rule has been breached.

- Appropriate escalation procedures, including whistleblowing, should be in place so that the firm can identify and appropriately investigate allegations of non-financial misconduct by employees both within and outside of the workplace.
- Staff must be appropriately trained on the importance of their behaviour within and outside of the workplace and when matters should be raised and to whom. Firms should also consider whether those to whom such matters may be raised also require training in handling what may be sensitive personal matters.
- Non-financial, as well as financial, metrics should be included in performance assessments.
- Sufficient management information regarding non-financial misconduct should be presented to management for management to receive a complete picture of risk, performance and conduct in the areas for which they are responsible.

[1] <https://www.fca.org.uk/publication/final-notices/russell-david-jameson-2020.pdf>

[2] <https://www.fca.org.uk/publication/final-notices/mark-horsey-2020.pdf>

[3] <https://www.fca.org.uk/publication/final-notices/frank-cochran-2020.pdf>

[4] <https://www.fca.org.uk/news/press-releases/fca-bans-three-individuals-working-financial-services-industry-non-financial-misconduct>

[5] <https://www.fca.org.uk/publication/correspondence/wec-letter.pdf>

[6] <https://www.fca.org.uk/news/speeches/opening-and-speaking-out-diversity-financial-services-and-challenge-to-be-met>

[7] <https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-non-financial-misconduct-wholesale-general-insurance-firms.pdf>



Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or the following authors in London:

Matthew Nunan (+44 (0) 20 7071 4201, mnunan@gibsondunn.com)

Martin Coombes (+44 (0) 20 7071 4258, mcoombes@gibsondunn.com)

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