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Client Alert
Commentary

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UK Regulators Set Out Policy Proposals on Misconduct; Diversity and Inclusion

The FCA and the PRA have published their long-awaited consultations which aim to formalise how firms approach diversity and inclusion.

Key Points:

- The FCA is proposing to introduce new guidance for all firms on non-financial misconduct.
- Larger firms would also be subject to new reporting and disclosure requirements on diversity and inclusion (D&I), and a requirement to set a D&I strategy and specific targets.
- PRA-authorised firms would need to allocate responsibility for D&I under the SMCR, and set a D&I strategy specifically for the board.
- The new requirements are likely to apply from 2025.

On 25 September 2023, the FCA and the PRA published separate but related consultation papers on D&I in financial services (FCA CP23/20 and PRA CP18/23). The regulators published a joint Discussion Paper in July 2021 on how they might accelerate the pace of meaningful change in relation to D&I and misconduct in financial services, by establishing minimum standards and providing firms with a better understanding of regulatory expectations (see Latham's related blog post).

While some of the regulators' proposed measures overlap, others are separate, and so dual-regulated firms will need to read both papers carefully. Equally, some of the measures would apply to all firms, but the more granular requirements would apply only to larger firms. Firms will therefore need to ensure they understand which requirements would be relevant to them.

The specific outcomes the regulators hope to achieve are: (i) creating healthier firm cultures; (ii) reducing groupthink; (iii) unlocking new talent; and (iv) fostering a greater understanding of, and provision for, diverse consumer needs (which the FCA links to its recently introduced Consumer Duty).

This Client Alert discusses the proposals in the FCA and PRA consultation papers, what new requirements they would introduce for firms, and what firms should do now to prepare for the proposed requirements.

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Non-Financial Misconduct

As well as detailed new requirements on D&I, the FCA is proposing new guidance on how firms should (and how the regulator would) consider non-financial misconduct when assessing fitness and propriety or applying the Conduct Rules. Despite a strong focus on non-financial misconduct in recent years, the FCA has not always been successful in its enforcement cases as regulatory expectations regarding such misconduct have not been made explicit. Presumably this new guidance is positioned to set some clearer expectations in this area to achieve more consistent outcomes for the FCA, particularly after the FCA has experienced some unfavourable results in the Upper Tribunal. Indeed, the FCA explicitly states, "We consider that articulating our views clearly in FIT would reduce the risk of inconsistency in how our guidance involving non-financial misconduct is interpreted and applied in firms and within judicial settings".

The FCA plans to add further explanations in FIT as to how non-financial misconduct can impact an individual's fitness and propriety. Importantly, firms should note the existing position that misconduct both within and outside the workplace can be relevant for FIT. The FCA proposes to explain that bullying and similar misconduct within the workplace is relevant to fitness and propriety and that similarly serious behaviour in a person's personal or private life is also relevant. It also proposes including other examples of non-financial misconduct, such as sexual or racially motivated offences.

Interestingly, the FCA believes that serious non-financial misconduct outside of work will almost always be relevant to an individual's fitness and propriety, either because it calls into question their integrity or threatens public confidence in the industry. The FCA explains that "Misconduct in the person's private or personal life may run a significant risk that the person would commit misconduct in their work activities that would breach the standards of the regulatory system". It adds that "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 there is little or no risk of it being repeated in their work for their firm. This will be the case if it is disgraceful or morally reprehensible or otherwise sufficiently serious." While this may align with the view taken by many firms, it differs from judicial views previously expressed in the Upper Tribunal.

The FCA is also planning to provide additional guidance in COCON regarding the treatment of non-financial misconduct. However, COCON does not cover private or personal life, and so there is a clear distinction between the approach firms should take when assessing fitness and propriety versus when they may find a breach of the Conduct Rules. Although COCON is ordinarily limited to apply only in relation to certain activities of the firm, the FCA is proposing to expand its scope to clarify that it always covers serious instances of bullying, harassment, and similar behaviour towards fellow employees and employees of group companies and contractors.

The FCA plans to add guidance on the types of behaviour that would fall within the expanded scope of COCON, and that may breach the Conduct Rules, as well as what conduct is out of scope because it relates to an employee's personal or private life. For example, the FCA indicates that an individual's misconduct towards a colleague at a social occasion organised by their firm would be in scope, whereas the same behaviour at a social occasion organised by the individual in their personal capacity would not. These examples provide helpful clarity in what is a difficult area for firms to navigate, although firms will doubtless continue to encounter grey areas when addressing these issues. This expansion of the scope of COCON in relation to behaviour towards fellow employees also makes even clearer that the increasing trend towards including harm to colleagues in firms' definitions of conduct risk (in addition to harm to clients, market integrity, and competition) is certainly in line with the FCA's expectations.

The FCA also plans to emphasise that not every instance of non-financial misconduct would amount to a breach of COCON. As a reminder, firms need to notify the FCA when they take disciplinary action against

an employee for a breach of the Conduct Rules. The FCA emphasises that it would only take disciplinary action for serious breaches of COCON, which could include particularly serious instances of bullying, harassment, or similar behaviour, or multiple instances that are collectively particularly serious. However, firms would face difficulty making such judgements, particularly when the impact of such behaviours is so subjective.

Further, the FCA is proposing to introduce additional guidance in relation to its rules on regulatory references, to clarify that non-financial misconduct may need to be disclosed, including potentially conduct in relation to someone outside of the work context, if relevant to an individual's fitness and propriety.

Finally, the FCA is proposing to extend the guidance on its Suitability Threshold Condition to include, for example, offences relating to a person's or group's demographic characteristics (such as sexual or racially motivated offences) and tribunal or court findings that the firm, or someone connected with the firm (such as a director), has engaged in discriminatory practices. This would mean that such matters would be relevant both at authorisation and when considering whether a firm should remain authorised on an ongoing basis.

D&I Requirements

Under the proposals, the regulators would require firms with 251 or more employees (larger firms), and in some cases all dual-regulated firms subject to the CRR or Solvency II parts of the PRA Handbook, to comply with certain new D&I requirements. The proposals would apply on a solo entity basis, and Limited Scope SMCR firms would be excluded from these requirements entirely.

Broadly, the requirements relate to strategy, targets, reporting, disclosure, and governance. See the Annex at the end of this Alert for a summary of which firms are within scope of which elements of the proposals. The overall tenor of the proposals is that firms should be given freedom and flexibility to decide what is appropriate for them. Therefore, the regulators are not proposing to set prescriptive targets. However, the regulators are including detailed reporting and disclosure requirements, so that firms' decisions regarding D&I and their progress towards their D&I goals would be open to considerable scrutiny.

Firms should consider now whether they are likely to be above the relevant threshold, as for firms that are and will remain below the threshold the proposals will have very limited impact. However, the regulators make clear that they would expect some firms below the threshold to consider applying the additional requirements on a voluntary basis.

To determine whether a firm is a larger firm, the regulators propose to rely on the average number of employees over a rolling three-year period as at a specified annual reference date. If a previously small firm calculates that its three-year average is 251 or more employees, it would have 12 months from the relevant reference date to meet the additional requirements for a larger firm (unless at that date its average number of employees has again fallen below the threshold). If a firm's average number of employees falls below the 251-or-more threshold as at their annual D&I reporting date, it would immediately fall outside of scope of the requirements for larger firms.

D&I Strategy

Under the proposals, larger firms, and all dual-regulated firms subject to the CRR or Solvency II parts of the PRA Handbook, would need to have a D&I strategy. This strategy would need to be easily accessible and free to obtain, for example by being freely available on the firm's website. The board would be responsible for maintaining and overseeing the strategy, although the regulators do not plan to mandate how frequently the strategy should be reviewed or updated. In relation to third-country branches, the PRA

has also stated that it expects relevant aspects of the D&I strategy proposals to be considered with regard to the firm's UK operations. Therefore such branches would need to think carefully about how the UK regulators' expectations align with any D&I strategy covering the branch at an international group level.

A firm's D&I strategy would need to take account of current progress and consider appropriate goals. As a minimum, the regulators indicate that the strategy would need to contain the following:

- The firm's D&I objectives and goals
- A plan for meeting and measuring progress against those objectives and goals
- A summary of the arrangements in place to identify and manage any obstacles to meeting the objectives and goals
- Ways to ensure adequate knowledge of the D&I strategy amongst staff

The PRA has also proposed the more overarching expectation that D&I strategies should include the firm's core values, the culture that it is trying to create, and its commitment to D&I. This expectation would require firms to take a holistic view of their approach to conduct and culture more generally and how their D&I strategy sits alongside that broader framework.

The FCA highlights that existing shortcomings with D&I policies it has observed include failing to clearly explain the strategy's purpose, and a lack of detailed actions explaining how a firm intends to achieve its aims. Firms should consider these areas when preparing their strategies.

Targets and Monitoring

Larger firms would be required to set "stretching but realistic" targets to address underrepresentation in their firms. The regulators would normally expect firms to set at least one target for each of the following categories: the board, senior leadership, and the employee population as a whole. Firms may choose to set inclusion targets on a voluntary basis in addition to the diversity targets. The FCA will not mandate which demographic characteristics the targets must cover, or what those targets should be. However, the PRA expects CRR and Solvency II firms to set targets for gender and ethnicity at a minimum. The regulators expect firms to take an appropriate approach considering factors such as the context in which they operate, their current diversity profile, and whether they wish to prioritise areas of greater underrepresentation first. Firms would be required to disclose the rationale for the targets chosen, and for CRR and Solvency II firms, those senior managers responsible for D&I would also need to be able to explain the rationale for setting the targets the firm has chosen and how this supports the implementation of their D&I strategy and policies.

Firms would need to review and update these targets regularly, but the regulators do not specify how often. Firms would, however, need to publicly disclose their targets and progress annually.

Under the FCA's proposed rules, the board would be responsible for overseeing the firm's targets, including monitoring progress, identifying obstacles to achieving them, and agreeing to plans to overcome such obstacles. The board would also be responsible for monitoring the diversity profile of the firm and the extent to which the firm achieves an inclusive culture, taking appropriate action to improve the firm's diversity profile and culture, and keeping a record of the monitoring and action undertaken. For CRR and Solvency II firms, the PRA has proposed a new rule for firms to monitor D&I internally so that firms can take appropriate actions to improve D&I if necessary.

Notably, the regulators are not proposing measures linking the regulatory approval of a firm to the demographic characteristics of its senior management population or wider staff. The regulators had considered this approach in the Discussion Paper but have decided it is not appropriate.

Reporting and Disclosure

The regulators plan to introduce a new regulatory return for D&I, to be submitted annually via RegData. A sample template of the form can be found on the FCA website.

All firms (except Limited Scope SMCR firms) would need to report their average number of employees using the return, so that the regulators can ascertain which firms are within scope of the more detailed requirements. Firms with 250 or fewer employees would not need to report any further information, although they could choose to do so voluntarily.

Larger firms would need to report additional D&I data. Firms would need to collect and report to the regulators data across a range of demographic characteristics, inclusion metrics, and targets. The return would include a number of mandatory and voluntary demographics for firms to report against. The mandatory demographics proposed are: age; sex or gender (firms can choose one); disability or long-term health condition(s); ethnicity; religion; and sexual orientation. Proposed voluntary demographics are: sex or gender (whichever is not included in a firm's mandatory disclosure); gender identity; socio-economic background; parental responsibilities; and carer responsibilities. The regulators expect to see more firms reporting against the voluntary demographics over time, and may consider moving to mandatory reporting against these demographic characteristics at a later date. The regulators plan to produce a regular aggregated disclosure report based on the data that firms report, so that firms can compare themselves with their peers.

The inclusion metrics that firms would need to report would cover whether employees feel:

- Safe to speak up if they observe inappropriate behaviour or misconduct
- Safe to express disagreement with or challenge the dominant opinion or decision without fear of negative consequences
- That their contributions are valued and meaningfully considered
- They are subject to treatment (for example actions or remarks) that has made them feel insulted or badly treated because of their personal characteristics
- Safe to make an honest mistake
- That their manager cultivates an inclusive environment at work

In relation to progress against targets, firms would need to provide the following information:

- The demographic characteristics they have set targets for, as well as their inclusion targets, if any
- The percentage at which each target has been set
- The year each target was originally set
- The year the firm is aiming to meet the target

- The firm's current level of representation against each target
- The rationale for the targets set
- Any further information the firm would like the regulator(s) to consider about targets they have set

Firms would need to provide data for all of the above against the categories of: board, senior leadership, and all employees (including the board and senior leadership).

The regulators are proposing that firms would need to submit their first round of data 15 months from the publication of the final rules. The reporting window would open 12 months after publication of the final rules, and larger firms would be able to report on a comply-or-explain basis for the first report. However, they would need to submit a complete report in the second reporting cycle. All firms would still need to provide data on their average number of employees in the first reporting cycle.

The regulators are also proposing that firms would need to disclose the same information that they report to the regulators publicly, albeit as percentages of the numbers of individuals in each category. The regulators expect that firms would make such disclosures on their websites, and information would need to be clearly presented and easy to understand. The information would also need to be presented in a consistent format each year to allow for easy comparisons — although the specific format would not be prescribed. Firms would also need to highlight any significant changes from previous disclosures in a summary. This disclosure would need to be made on an annual basis, either alongside the firm's annual report and accounts or within six months of the end of their financial year. Firms would be able to choose the reference date.

Firms may well be concerned about possible issues with disclosing this potentially sensitive data publicly. To try to assuage this concern, the regulators propose that firms would be able to disclose against some of the mandatory demographics and all of the voluntary demographics using just two categories: board and senior leadership (combined), and all employees. Firms would be able to aggregate the information further if disclosure in more granular categories might result in disclosure of information that could identify an individual. The regulators also note that firms would not be required to make disclosures that breach the GDPR (or other applicable legislation), but it is up to firms to assess this. Disclosures would be voluntary in the first year, becoming mandatory after that.

Risk and Governance

The FCA is proposing a new rule for larger firms to clarify that matters relating to D&I would need to be considered a non-financial risk and treated appropriately within the firm's governance structures. The FCA has not limited this to the audit function, and wants firms to consider how a range of relevant functions, including risk management and compliance, can contribute to progress on D&I. The FCA stresses that D&I must not be seen as a "tick box" compliance issue.

Board Governance

The FCA is not making proposals on board recruitment, succession planning, and talent pipelines. It considers that its proposals for larger firms on D&I targets are sufficient.

However, the PRA is proposing to amend the existing requirements for board recruitment and policies to promote board diversity that apply to CRR and Solvency II firms, to require such firms to put in place a strategy promoting D&I for the board, which should also apply to board sub-committees. Firms would need to publish their board D&I strategies on their websites, alongside the firm-wide D&I strategy, to

ensure stakeholders can access and understand them holistically as a package. The PRA will also update its rules to include diversity as a consideration in succession planning.

Senior Managers

The FCA has decided not to require a Senior Manager within each firm to be assigned responsibility for D&I. However, it notes that although it is not required for FCA firms, some may find it helpful to allocate responsibility for culture or D&I to a specific Senior Manager.

For dual-regulated firms in scope of the prescribed responsibilities (PRs) for culture, the PRA proposes to include responsibility for the development and implementation of D&I strategies within those PRs. Therefore, the SMFs currently holding the PRs for leading the board's development of the firm's culture (PR I) and for overseeing the adoption of the firm's culture in the day-to-day management of the firm (PR H) would need to update their Statements of Responsibility to include responsibilities for D&I. The PRA states it expectations for each of these SMFs to be:

- **PR I:** The relevant SMF would be responsible for ensuring the board sets, approves, and adopts an appropriate D&I strategy, and ensuring that all members of the board have adequate time and opportunity to contribute to developing the strategy and providing independent challenge.

- **PR H:** The relevant SMF would be responsible for ensuring the board's strategy is implemented across the firm, and ensuring all business areas understand the role they play in implementation. The SMF holding PR H would also be expected to have their performance against their D&I responsibilities reflected in their remuneration decisions via risk adjustments (if applicable).

For dual-regulated firms not in scope of PR I and PR H, at least one Senior Manager would need to be allocated responsibility for implementing the firm's D&I strategy. If they hold an executive SMF, their performance against D&I responsibilities should be reflected in their variable remuneration decisions.

Importantly, the PRA notes that the intention is not to hold Senior Managers accountable for a failure to meet diversity targets. Rather, the goal is for those Senior Managers to be able to understand and discuss with the PRA the reasons that firms set certain D&I targets and if they will not be met, the reasons for this. The PRA provides guidance on what would amount to "reasonable steps" in this context in relation to the proper discharge of a Senior Manager's D&I responsibilities, including "demonstrable efforts to implement a well-developed and evidence-based strategy, and an understanding of how a firm should address strategic shortcomings on D&I over time".

Next Steps

The regulators have requested responses by 18 December 2023. They plan to publish their Policy Statements in 2024, with the final rules and guidance coming into effect in 2025 (12 months after the publication of the Policy Statements). Firms should consider now which of the proposals could apply to them. If the more detailed D&I requirements are likely to apply to them, they should begin to consider how they could implement them, in particular how they would gather the necessary data from their employees.

The regulators are not proposing any formal requirements on D&I training, but firms will need to familiarise employees with their approach and their new policies on D&I, if relevant, and so firms will also need to consider this as part of the implementation process.

In terms of the outcomes the regulators are expecting to see from this work, the FCA provides some key measures it is hoping firms will achieve:

A healthy culture	Initially, we [FCA] expect clearer guidance on non-financial misconduct and discriminatory practices would lead to an increase in instances of firms reporting disciplinary actions to us. We would also seek to measure success through improved staff inclusion scores on the proposed D&I regulatory return.
Reduced groupthink	Improved staff inclusion scores on the proposed D&I regulatory return, including on willingness of employees to provide constructive challenge. This can also be measured via our proactive supervisory engagement.
New talent unlocked	Board, senior management and employee diversity increases on average across regulated firms, measured through the proposed D&I regulatory return.
Greater understanding of, and provision for, diverse consumer needs	Improved consumer feedback and improving rates of financial inclusion (as measured through our Financial Lives Survey or other sources of consumer research) can be indicative of the extent to which products and services are being better tailored to consumers' needs.

Source: FCA

This helps to give firms an idea of what they are aiming for, and how they might be able to meet regulatory expectations.

Annex — Application

Proposal	Firms in scope
Guidance on Non-Financial Misconduct	All FSMA firms with a Part 4A permission and where relevant Threshold Conditions and existing chapters of the Handbook apply
Data Reporting	All FSMA firms with a Part 4A permission need to report their number of employees annually, excluding all Limited Scope SMCR firms All FSMA firms with a Part 4A permission with 251 or more employees have additional reporting obligations, excluding all Limited Scope SMCR firms
D&I Strategy	Dual-regulated CRR and Solvency II firms of any size (firms to which the CRR or Solvency II parts of the PRA Rulebook apply) All other FSMA firms with a Part 4A permission that have 251 or more employees, excluding all Limited Scope SMCR firms
Data Disclosure	All FSMA firms with a Part 4A permission with 251 or more employees, excluding all Limited Scope SMCR firms
Setting Targets	
Risk & Governance	
Monitoring	Dual-regulated CRR and Solvency II firms of any size (firms to which the CRR or Solvency II parts of the PRA Rulebook apply)
Board Governance	Dual-regulated CRR and Solvency II firms of any size (firms to which the CRR or Solvency II parts of the PRA Rulebook apply)
Senior Managers	Dual-regulated CRR and Solvency II firms of any size (firms to which the CRR or Solvency II parts of the PRA Rulebook apply)

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