Next steps for diversity and inclusion in financial services: FCA and PRA proposals

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Diversity makes business sense, from both a financial and consumer perspective. Research in financial services has demonstrated a positive link between diversity at senior levels within firms and positive outcomes. However, the financial sector still has some way to go: while some progress has been made, large gender and ethnicity pay gaps exist and there remains a lack of diversity at leadership levels.

To address these issues, the UK Financial Conduct Authority (FCA) (see https://www.pdpjournals.com/docs/99039) and the Prudential Regulatory Authority (PRA) (see https://www.pdpjournals.com/docs/99040) released consultation papers on 25 September 2023 proposing to introduce a new regulatory framework on diversity and inclusion (D&I) in the financial sector.

The consultations follow on from the regulators' joint discussion paper, launched over two years earlier in July 2021, and set out proposals for measures to improve D&I in financial services. Released "in parallel", the proposals are intended to be consistent and coordinated, and are substantially the same – feedback is requested on divergences that might create implementation challenges. That being said, the PRA's framework also has some additional requirements for dual-regulated firms not included in the FCA's proposals, most notably in relation to senior management accountability.

Both consultations close on 18 December 2023. The FCA expects to develop final regulatory requirements for publication in 2024, with an implementation period of 12 months after publication of the final rules to give firms time to prepare. The PRA has not set out a timeline for publication of its final rules, but in practice we anticipate that it will be similar. It has confirmed that it will provide the same 12-month implementation period.

In summary, both sets of proposals will:

- require reporting and disclosure of diversity and inclusion data;
- require firms to establish, implement and maintain a D&I strategy;
- require firms to set diversity targets to address underrepresentation;
- require firms to recognise a lack of D&I as a non-financial risk; and
- embed non-financial misconduct (NFM) into the FCA Handbook within the Conduct Rules, staff fitness and propriety assessments, and the suitability guidance on the Threshold Conditions.

The regulators' proposals will not be surprising – both D&I and NFM have remained steadfastly on the regulatory agenda for some time now. In the FCA's view, firms that foster a culture of genuine inclusion are places where employees feel safe to speak out. Psychological safety is also critical to an inclusive culture and, of course, a workplace in which NFM, such as bullying and harassment, is permitted to flourish does not contribute to a healthy "speak up" culture.

The importance of diversity and inclusion

Nikhil Rathi, Chief Executive of the FCA, has said that for UK financial services to be competitive and for companies within the sector to be well run with healthy working environments, "it's vital they attract, retain and promote the best talent".

The regulators place value on diversity and inclusion beyond the nine protected characteristics in the Equality Act 2010 (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation). Whilst all of these are important, the regulators prize diversity as a means to achieving diversity of thought, which recognises how different perspectives, skills, and knowledge inform problem-solving approaches. Diversity of thought is influenced by many factors including demographic characteristics such as sex or race.

Diversity alone is not enough, as the July 2021 joint discussion paper made clear. An inclusive culture is needed to "enable the benefits of diversity of thought to flourish in practice". Inclusive policies provide equal access to opportunities and resources to everyone, including those who might otherwise be excluded. All individuals are able to participate freely; speak up without fear of reprisals; and know that their views will be fully considered. This reduces risk to consumers and clients, and enables whistleblowing policies and procedures to work as they should.

D&I strategies

In the regulators' proposals, certain firms will need to establish D&I strategies, set appropriate targets, and report to the regulators.

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While many firms will already have a D&I policy in place, the proposals mandate the establishment and maintenance of a strategy to be overseen by the board and require that these are evidence based. At a minimum, the strategy must include the firm's D&I objectives and goals, plans for monitoring progress, arrangements that are in place to identify and manage obstacles, and ways to ensure adequate knowledge of the D&I strategy among staff. The PRA also expects that the risk and control functions will support the strategy, although it does not add additional prescriptive requirements to this effect.

In addition to the firm strategy, the PRA proposes to require firms to have and publish a strategy specifically promoting diversity and inclusion on the board, with expectations on succession planning and board/subcommittee responsibilities for D&I.

Targets

Firms will also be required to determine and set appropriate diversity targets to address underrepresentation. The FCA proposes that separate targets will need to be set for each of the board, its senior leadership, and the employee population as a whole, with firms also able to set inclusion targets on a voluntary basis. Note that in-scope overseas firms are not required to set a target for the areas of the firm that are based overseas (e.g. board or senior leadership). The PRA will expect firms to set targets for women and ethnicity at a minimum, if underrepresentation is identified.

Reporting

The regulators propose to require that firms in scope collect, report and disclose D&I related data across a range of demographic characteristics, inclusion metrics and targets via an annual joint regulatory return. Data collection is not a tick box exercise; a theme running through the consultation is the need for evidence-based strategies. Data gathering is therefore a key step to identifying areas for intervention, setting appropriate targets, measuring progress and change and, crucially, a way for firms to hold themselves to account. Mandatory characteristics will include age, sex or gender, ethnicity, disability or long-term health conditions, religion, and sexual orientation. Voluntary characteristics will include gender identity, socio-economic background, parental responsibilities, and carer responsibilities.

As noted, firms can choose to report on sex or gender or both, but must report on at least one of these. Firms seeking to address the under representation of women will typically look to draw on the positive action provisions of the Equality Act, which recognises sex as a protected characteristic rather than gender. Relying on these provisions will therefore require collection and analysis of data on sex, and for this reason, we recommend firms opt to report on sex.

The reporting proposals also include a number of inclusion metrics, based on firms asking their employees (for example, via an anonymous survey), to what extent they agree that they:

- feel safe to speak up if they observe inappropriate behaviour or misconduct;
- feel safe to express disagreement with or challenge the dominant opinion or decision without fear of negative consequences;
- feel as though their contributions are valued and meaningfully considered;
- have been subject to treatment (for example, actions or remarks) that have made them feel insulted or badly treated because of their personal characteristics;
- feel safe to admit an honest mistake; and
- think their manager cultivates an inclusive environment at work.

Finally, firms will also need to include information on their progress against the targets they have set for themselves.

Data, inclusion metrics, and target progress will need to be reported across the three layers of the board,

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senior leadership and all employees. Employees must also be able to choose not to respond to the survey, or to indicate that they prefer not to say in respect of any of the categories being collected.

Note that the PRA and the FCA also propose to use the data collected to produce an aggregated industry-wide benchmarking report.

The collection and processing of diversity data will be a particular challenge, especially for firms with a presence in more than one jurisdiction who would like to develop a consistent global policy. Much of the diversity data set out above is special category data under the GDPR and UK GDPR and this means that the processing of it is subject to a number of additional compliance steps and processing restrictions. The fact that definitions and practices vary internationally must be taken into account, for example in France it is unlawful to collect ethnicity data other than in special circumstances.

Risk and governance

The FCA proposes to introduce new guidance clarifying that a lack of D&I should be recognised as a non-financial risk, which should be addressed across a range of relevant functions (e.g. audit, risk, HR, compliance) within the firm's governance structure. The FCA has decided not to prescribe how these risks should be addressed, instead affording firms the flexibility to implement the guidance in a way that is aligned with their business and governance.

The PRA also proposes to require firms to monitor D&I internally and to take appropriate actions where necessary.

Individual accountability

In a significant divergence from the FCA's consultation, under the PRA's proposals responsibility for D&I is expected to be allocated to the relevant senior management functions (SMFs) under the Senior Managers and Certification Regime (SMCR), with this reflected in Statements of Responsibilities, and measures for accountability put into place. The PRA also clarifies that objective findings of patterns of behaviour such as bullying, discrimination, and harassment can be considered as part of fitness and propriety assessments (though no rule changes are proposed).

The FCA does not propose to allocate D&I to an SMF. This aligns with the positions taken by the regulators in relation to culture: under the PRA rules, dual-regulated firms are required to allocate culture to an SMF. Under the FCA rules, overall responsibility for culture – and by extension in the proposals, D&I – does not need to be allocated to a specific SMF. However, the FCA considers that firms may find it helpful to do so to focus attention on D&I.

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Non-financial misconduct

Non-financial misconduct (NFM) has been a regulatory hot topic for the FCA since at least May 2018 when Megan Butler (then Executive Director of Supervision - Investment, Wholesale and Specialist division) gave evidence before the House of Commons' Women and Equalities Committee. In her evidence, she stated that misconduct is misconduct, whether it is financial or non-financial, and that a culture in which sexual harassment was tolerated would not be conducive to a speak-up culture.

Since that time, a number of further speeches and letters from the regulator have given a clear indication of the importance that the FCA attaches to NFM insofar as it may have an impact on the workplace by discouraging individuals from speaking out.

Where serious offences are concerned, the individual's integrity may be called into question and the reputation of the individual and the firm may also be undermined. However, some caution is required as there has to be a connection between the way in which NFM, particularly offences outside of work, affects the individual's ability to perform their role in a regulatory context, a connection that the FCA has struggled to evidence in enforcement actions. In this context, the FCA's consultation proposes a number of amendments to its rules to explicitly embed NFM within the Handbook. While the PRA is not making any new rules, as noted above it has clarified its existing expectation that conduct such as bullying, discrimination, and harassment could be relevant to fitness & propriety assessments.

The FCA proposes to include NFM explicitly within the Conduct Rules, staff fitness and propriety assessments, and the suitability guidance on the Threshold Conditions:

- **Fitness and propriety assessments**: The FCA has proposed additional guidance on how NFM should be incorporated into regulatory references. This includes clarifying that bullying and similar misconduct within the workplace is relevant to fitness and propriety and that similarly serious behaviour in an individual's personal or private life is also relevant. Examples of NFM, such as sexual or racially motivated

offences, are provided. The FCA has also provided clarification that serious NFM conduct, which the FCA considers could damage public confidence in the UK financial system (as has happened where individuals have committed serious NFM, whether inside or outside the workplace, such as sexual or racially motivated offences, but are permitted to continue working within the sector) is likely to mean that the person is not fit and proper.

- **Conduct Rules**: The FCA proposes to expand the scope of the Conduct Rules to clarify that they cover serious instances of bullying, harassment and similar behaviour towards fellow employees and employees of group companies and contractors – this would cover serious misconduct only, and the exception would be where the misconduct clearly relates to a part of the firm's business that does not carry on any financial services activities (in line with the FCA's existing regulatory remit). Additional guidance is proposed on the types of behaviour that would fall within the expanded scope, and that may breach the Conduct rules, and on what conduct is out of scope because it relates to an employee's personal or private life.

- **Suitability guidance**: The FCA proposes to extend the guidance on the Suitability Threshold Condition to include, for example, offences relating to a person 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.

Closing the "Frensham gap"

It seems clear that these proposals are also aimed at closing the so-called "Frensham gap" by explicitly linking serious behaviour in a person's personal or private life to fitness and propriety, as well as to potential damage to wider public confidence in the financial system.

Jon Frensham, an independent financial adviser, was banned by the FCA after his conviction for attempting to meet a child under the age of 16, following acts of sexual grooming, which occurred while he was an approved person. In banning him, the FCA considered that he lacked integrity. Mr Frensham challenged the ban in the Upper Tribunal, the first NFM case to be considered by the Tribunal not involving dishonesty and where the behaviour concerned was unrelated to the regulated activity.

In its decision, the Tribunal explained that, in its view, it was not just a question of assessing whether the behaviour concerned demonstrates a lack of integrity at large, but also whether the behaviour engages the FCA's specific standards so that the behaviour in question affected the practice of the profession or professional standing. Further, the FCA's guidance (FIT 2.1) on assessing fitness and propriety also states that a conviction for a criminal offence would not automatically mean the person should be found not to be "fit and proper" – 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.

Whilst the Tribunal ultimately found for the FCA, it was not persuaded by the FCA's attempt to "bridge the distance" between Mr Frensham's offence and the consumer protection objective – the Tribunal found that the evidence did not show a lack of integrity when dealing with clients. Given that a majority of Mr Frensham's clients stayed with him, the FCA did not convince the Tribunal that the conviction would undermine consumer confidence or the integrity of financial systems. Consequently, the Tribunal concluded that the offence itself was not sufficient to justify the prohibition order. Instead, the Tribunal found that Mr Frensham's conduct after he was arrested and charged (including, for example, failing to notify the FCA of his arrest and remand, and his lack of remorse) demonstrated a lack of integrity.

While firms may welcome greater guidance as to how NFM should be considered as part of the fit and proper assessment, the definitions proposed may cause some concern. By way of example, the definition of "discriminatory practices" includes discrimination and harassment due to "demographic characteristics". The term demographic characteristics is not defined – it is presumably intended to address socio economic status but, bearing in mind that discrimination and harassment can be unintentional, and the potential career consequences of an individual being found responsible for discriminatory practices are serious, this ambiguity is a cause for concern.

The proposals also introduce into the Conduct Rules a definition of harassment that goes beyond that in the Equality Act. The Equality Act defines harassment as conduct that relates to a protected characteristic and which has the purpose or effect of violating another person's dignity, or creating an intimidating, hostile, degrading, humiliating, or offensive environment for them. The proposed COCON amendment starts with the same definition but also includes conduct that "is unreasonable and oppressive" or "humiliates, degrades or injures" the other person. It is unclear why the FCA has added these additional words, and particularly the reference to "unreasonable" conduct, which may create ambiguity.

The draft harassment definition also omits an important safeguard to interpretation in the Equality Act. The Act states that harassment will be unlawful if it has the prohibited effect even if that was unintentional, but states that when considering if the actions have that effect, account should be taken of the other person's perception, the circumstances, and whether it is reasonable for the conduct to have that effect. This is designed to ensure a level of objectivity in the assessment. Again, it is unclear why this was omitted from the draft Conduct Rules. The draft COCON 1.3 does include a series of general factors for assessing misconduct

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in relation to colleagues, including whether the conduct is repeated, its duration, degree of impact, and likelihood of damage to culture. It also considers relative seniority of those involved and whether the conduct would justify dismissal.

These are also important safeguards but, given that there is a well-trodden path of existing case law addressing the Equality Act definition of harassment, it would seem more appropriate to limit the definition of harassment to that in the Equality Act, and to include the guidance on determining whether it is reasonable for conduct to have had the effect complained of in addition to the proposed general factors.

The proposed amendments to FIT include a detailed explanation of why conduct outside of work may be relevant to suitability for a regulated role. Unsurprisingly, the FCA regards dishonesty outside of work as always relevant to the fit and proper assessment. However, the amendments go on to say that conduct outside of work which does not involve "a breach of standards that are equivalent to those required under the regulatory system" may also be relevant to whether a person lacks "moral soundness, rectitude and steady adherence to an ethical code".

The amendments suggest that this could be the case if conduct is disgraceful or morally reprehensible or otherwise sufficiently serious. While it is easy to see that violent, sexual or racially motivated conduct, or the commission of a criminal offence is relevant to fitness and propriety, terms such as "disgraceful" and "morally reprehensible" introduce a significant degree of ambiguity.

Proportionality in application

The regulators' proposals will apply proportionately. The FCA proposes a baseline standard for in-scope firms and additional requirements for large firms and the PRA's requirements will apply in a similar way. The proposals will apply differently to firms depending on their number of employees, their categorisation under the SMCR, and whether they are dual-regulated. To reduce regulatory burden, smaller firms with fewer than 251 employees will be exempt from many of the requirements.

The proposals apply on a solo entity basis to ensure that progress is made at an individual firm level. However, firms may decide to apply a consistent approach across a group if they wish to do so.

Territoriality

Apart from those relating to NFM, fitness and propriety and the application of Threshold Conditions, the FCA and PRA proposals will apply only to employees that carry out their activities predominantly from an establishment in the UK. For overseas firms, the proposals apply only to activities of the firm that are carried out from an establishment in the UK.

Proposals not taken forward

Firms will be pleased to note that the FCA has decided not to take forward many of the more burdensome proposals originally floated in the July 2021 joint discussion paper, including:

- measures linking regulatory approval of a firm to undertake regulated activities to the demographic characteristics of its senior management population or wider staff;
- requiring an individual within each firm to be assigned responsibility for D&I (though again the PRA will require this, and the FCA encourages it if firms think it would be helpful);
- mandating a specific training requirement;
- introducing new product rules and guidance (this is covered by the Consumer Duty, which integrates D&I considerations into product rules and guidance); and
- linking remuneration to non-financial metrics.

However, firms should be mindful that the FCA has left the door open for introduction of some of these more onerous requirements in due course, in particular in relation to remuneration.

Not a starting point, but a next step

The consultations are open until 18 December 2023 and all firms and individuals with views on the proposals are encouraged to respond. Whatever the detailed outcome of the consultations, the direction of travel by 2025 is clear.

The joint regulators have been watching this area for some time as part of their focus on culture, governance, and the wider environmental, social and governance (ESG) agenda. While some progress has been made, it has not gone far enough, and D&I remains a regulatory concern in the spotlight. This will undoubtedly mean increased scrutiny of regulated firms and individuals as we move forward.

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