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**Freshfields Bruckhaus Deringer**

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## Freshfields FS insights

### Regulation of culture in financial institutions: global trends and challenges

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Around the world, regulators have become increasingly concerned about culture in financial services firms, as part of a wider focus on environmental, social, and governance (ESG) issues. However, there are significant differences in the approach taken by different jurisdictions with regard to issues such as diversity and inclusion (D&I) in financial services, as well as non-financial misconduct, which can present challenges for firms with a global footprint.

In this newsletter, we compare and contrast what is happening in the UK, the EU and the US with regard to these issues. For more information, please see our recent [webinar](#) on the topic.

#### **UK: new D&I reporting, disclosure and target-setting requirements**

In the UK, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) published consultation papers in September 2023 on D&I in financial services, in which they emphasise the importance of firm-wide D&I strategies and propose to

introduce new reporting, disclosure and target-setting requirements for regulated firms, as well as strengthen their expectations around non-financial misconduct. For a detailed examination of the proposals, see our [blog post](#).

The FCA and PRA believe that promoting D&I will contribute to a healthy workplace culture and reduce groupthink by enabling a broader range of perspectives. They also consider that D&I will enable financial institutions to attract and retain the best talent from a broader pool of candidates. Ultimately, the aim is for D&I to contribute to better governance and decision-making, as well as better risk management, which in turn will contribute to the safety and soundness of firms and improvements in outcomes for consumers and markets.

The regulators recognise that there has already been some progress made in a number of areas covered in the proposals, but they want to raise standards further and accelerate the pace of development in this area. They are also expanding their focus to include different and new diversity characteristics, as well as inclusion. The intention is to give firms the flexibility to develop solutions that work for them, albeit within a regulatory framework.

In terms of the specific proposals, the FCA and PRA are proposing to require financial institutions to develop a firm-wide D&I strategy. Although many UK firms already have such a strategy in place (often in the form of a D&I policy), the regulators identified a number of shortcomings with respect to those policies, such as failing to explain the purpose or set out the specific aims they are trying to achieve and the actions they are taking to achieve those aims.

Firms would also be required to set diversity targets that are meant to address the particular under-representation that they see within their firm. While the FCA doesn't mandate the demographic characteristics that those targets need to cover, the PRA would require firms to set targets for women and ethnicity at a minimum, unless they can demonstrate that there is no evidence of underrepresentation in those areas. Overseas firms that do not have a board or senior leadership in the UK would not need to set targets in those areas.

The proposals would also require annual collection and reporting of data to the regulators on a wide range of demographic characteristics, some of them on a voluntary basis and some mandatory. Firms would also be required to report on a selection of inclusion metrics as well as provide information on their targets, including the demographics they have been set for and the timeline for meeting those targets.

Public data disclosure would largely mirror the data that has been reported to the regulators, but in percentages rather than whole numbers. In addition, firms would need to disclose their firmwide D&I strategy, and PRA firms would need to make the Board's D&I strategy available on the firm's website.

The FCA and PRA also expect D&I-related matters to be supported by appropriate risk and control functions within the firm. This is not purely an audit matter, but will involve risk management, compliance and other support functions more broadly.

The UK proposals have been developed in close coordination between the FCA and PRA, though there are some divergences in the approach taken by the two regulators, and the PRA's proposals have some additional requirements for dual-regulated firms. For example, the PRA would require a senior manager within firms to be assigned responsibility for D&I, which would not be the case for solo-regulated firms.

## **An increased focus on non-financial misconduct**

The FCA consultation paper also covers non-financial misconduct, which is only briefly mentioned in the PRA's consultation. "Non-financial misconduct" refers to personal conduct outside the strict scope of regulatory or financial issues. Prime examples include bullying, harassment, and discrimination, which are a major focus of the FCA and PRA in their proposals, but it could also include other misconduct such as theft or violence.

In some respects, it is not a big leap from D&I to non-financial misconduct. After all, discriminatory behaviour or harassment can have a damaging effect on a firm's culture and the success of D&I initiatives. Furthermore, the FCA's focus on non-financial misconduct is not new, and it has stated previously that conduct such as sexual harassment can be relevant to the assessment of a regulated individual's fitness and propriety. Recently, the FCA's Sara Pritchard stated that the FCA will be writing to wholesale banks and insurers to request data on instances of sexual misconduct, methods of detection and resolution, and the use of non-disclosure agreements.

Firms have in the past faced the challenge of trying to determine where the FCA draws the line when it comes to non-financial misconduct. The new proposals should help them navigate this tricky area.

There are three core areas where non-financial misconduct issues might need to be considered by firms:

- fitness and propriety (which includes not only core competence for the role but also factors such as honesty, integrity and reputation)
- Principle 11 notifications, and
- the conduct rules, which apply to the majority of staff in regulated firms and include a requirement to act with integrity.

The FCA's consultation paper provides guidance on, for example, what kinds of misconduct are relevant to fitness and propriety and the conduct rules. Although the guidance doesn't touch specifically on Principle 11 notifications, the indicators of what will be relevant from a fitness and propriety or conduct rules perspective may give a pointer as to what the FCA would expect to be notified under Principle 11. The FCA makes clear that serious non-financial misconduct in an individual's personal life as well as at work is relevant to a firm's assessment of that individual's fitness and propriety. Serious bullying and harassment could also constitute breaches of the conduct rules, though the conduct rules only apply to misconduct in the workplace.

In addition, any misconduct relevant to an individual's fitness and propriety may need to be included in regulatory references provided by a firm to a prospective employer.

Non-financial misconduct could have an impact on a firm's ability to meet its suitability threshold conditions. The FCA is proposing to extend its guidance on these threshold conditions to include offences related to demographic characteristics such as sex or race. If a court finds that a firm or someone connected with the firm has engaged in discriminatory practices, this could result in the firm failing to meet that threshold condition. As a consequence of this guidance, firms might increasingly seek to appeal findings made against them in relation to discrimination.

The FCA's proposals provide some much-needed clarity, but there is much that

remains unclear. For example, how does the new guidance relate to misconduct that happened in the past, long before the guidance comes into effect? The new regime could also lead to a hardening of attitudes by employers when making employment decisions, as firms potentially take a stricter approach to the types of misconduct that is highlighted in the FCA guidance. This, in turn, could lead to increased litigation.

At least one takeaway is clear: historically, non-financial misconduct has been viewed as mainly the domain of HR and not compliance teams, but in light of the FCA's approach this should not remain the case. Financial services firms need to balance employment law risk with regulatory obligations. Navigating the new regime will require increased collaboration between the HR, compliance and legal teams within firms to ensure that all relevant considerations are balanced and risks managed.

### **EU: ongoing enforcement of existing rules**

There are no initiatives in the EU that are comparable to the measures proposed by the UK regulators. However, the issues of culture and diversity continue to be the subject of ongoing regulatory debate in the EU. The focus of that debate is not on new rules, but rather the enforcement of existing rules and expectations, particularly with regard to diversity.

The EU requirements for financial institutions in relation to diversity can be broadly divided into two categories: those that are intended to promote D&I, especially at the board level, and rules intended to promote the principle of equal pay for equal work.

The D&I requirements were implemented in the EU following the global financial crisis. They applied in the UK as well before Brexit, though they have been further developed by the European Banking Authority (EBA) since the UK left the EU, most significantly through the EBA's 2021 revisions of its guidelines on suitability assessments and internal governance.

The most important requirement is for all banks to have a policy promoting diversity on the management board with regard to factors such as professional and educational background, gender and age, as well as geographical provenance for those firms that operate across borders. Firms are required to set gender targets and develop a strategy for achieving those targets. These targets must be quantitative for significant institutions—including those supervised by the European Central Bank (ECB)—which must also annually disclose those targets and progress on achieving them. Firms must also adopt staff diversity and anti-discrimination policies.

With regard to culture more generally, institutions must have a Code of Conduct setting out principles and examples of acceptable and unacceptable behaviour, linked in particular to financial misreporting and misconduct. Institutions are required to monitor compliance with these standards, and breaches must result in malus and clawback of compensation.

In order to promote equal pay for equal work, firms are required to have gender neutral remuneration policies. In addition, firms must monitor the gender pay gap—this can be complex in practice, as differences in pay may be due to other factors such as length of professional experience.

Statistics derived from benchmark reports published by the EBA since 2016 reveal that over a quarter of EU financial institutions have yet to adopt a diversity policy, though compliance rates are significantly higher among ECB-supervised banks.

Female board representation has improved over that time, but progress is considered too slow and insufficient. The EBA has encouraged competent authorities to review diversity policies and take measures where shortcomings are identified. The so-called Women on Boards Directive, which was adopted at the end of 2022 and sets gender quotas for boards of listed companies, should further promote progress in this area across the EU.

Recently, the ECB in particular has been very active with a view to promoting diversity on boards. The ECB not only revised its Guide to fit and proper assessments—introducing gender diversity as an additional dimension of collective suitability—but also made management board effectiveness and diversity part of its supervisory priorities for the years 2023-2025. According to the ECB, it will continue to strive to achieve progress in this area through targeted reviews and on-site inspections as well as fit and proper assessments and re-assessments.

### **US: a different regulatory landscape, but litigation risk remains**

The landscape in the United States is very different. Banking regulators have yet to impose requirements similar to those in the UK and EU, although the Federal Deposit Insurance Corporation (FDIC) in 2023 issued a request for FDIC-supervised institutions to voluntarily conduct and submit self-assessments of their diversity policies and practices, which suggests an increasing focus on these issues and a desire for firms to engage in self-reflection and self-policing of compliance with D&I metrics.

In addition, diversity quotas at state level for publicly traded companies and Nasdaq board diversity disclosure rules, which were upheld by the US Court of Appeals in October 2023, could have an impact on financial institutions, and the Securities and Exchange Commission (SEC) has indicated that it may propose enhanced diversity disclosure requirements for SEC-registered companies in 2024. On the other hand, the US Supreme Court's June 2023 ruling on affirmative action in higher education, while not directly applicable to financial institutions, has cast a shadow over even private sector D&I initiatives.

Even in the absence of a specific regulatory framework, however, financial institutions still need to take steps to minimise the risk of workplace misconduct and be prepared to handle grievances when they arise. The investigation of alleged non-financial misconduct by employees, including sexual and racial discrimination and harassment, continues to be a critical and complex challenge for many companies and boards. These issues are arising with increasing frequency, guided by forces such as the Me Too Movement and Black Lives Matter, and they present increasing reputational and litigation risks.

For insights on other financial services topics, you can review our earlier editions [here](#).

If you would like to provide feedback on this or other editions, please contact [Laura Feldman](#).

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