ALLEN & OVERY

The FCA's 5 Conduct Questions: Translating theory to practice

In September 2020, the FCA published its latest feedback on its '5 Conduct Questions' programme. This year, the FCA has opted not to structure its feedback by reference to its 5 conduct questions. Rather, it has focused on some key topics that relate to firms' conduct and culture programmes, including the identification of conduct risk, remuneration and performance assessments, leadership and speaking up.

The FCA's 5 Conduct Questions

1. What proactive steps do you take as a firm to identify the conduct risks inherent within your business?
2. How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?
3. What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?
4. How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and, equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?
5. Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?

Throughout its report, the FCA includes examples of 'emerging best practice' in particular areas. However, firms still face the considerable task of taking the FCA's latest feedback and translating that into practical and tangible actions. Below we set out some practical considerations for firms to support the review and development of their conduct and culture programmes based on the FCA's latest feedback.

Although the FCA's latest feedback on its 5 Conduct Questions programme has been based on observations made about wholesale banks, other financial services firms should take note of the FCA's feedback on this topic.

Identification of conduct risk

The FCA found that the understanding and identification of conduct risk on a day-to-day basis remains '*unacceptably weak*'.

More well-known areas of conduct risk appear to be reasonably well understood by employees, such as conflicts of interest, treating customers fairly, diversity and non-financial misconduct. This feedback represents a significant improvement on the feedback that the FCA has given on this topic in previous years. However, the FCA highlighted a '*worrying*' lack of awareness in relation to a wider range of conduct issues that are '*emerging all the time*'. Examples of newer conduct risks highlighted by the FCA include the risks arising from automation, the impact of LIBOR transition and, more recently, risks associated with employees working from home.

The FCA made it clear that firms need to adopt a more 'front of mind' understanding of conduct risk and that they need to improve their ability to identify and mitigate new sources of conduct risk as they emerge. However, this feedback is not new and it has featured in previous feedback that the FCA has published as part of its 5 Conduct Questions programme. Firms therefore face the challenge of how to renew their efforts relating to conduct risk and fight conduct risk 'fatigue'.

Key points that firms should consider in light of the FCA's feedback on this topic are as follows:

- **Conduct risk frameworks**: Firms should consider whether their conduct risk frameworks are sufficiently clear. For example: Do they distinguish between conduct risks, conduct causes and conduct events? Do they confuse conduct risks with operational risks? Having clarity on the definition of the term 'conduct' will also facilitate more effective and productive identification of conduct risks at all levels in a firm.
- **Role of the second line of defence**: The FCA has made it clear that conduct risk programmes tend to be less effective if they are primarily driven by the second line of defence. However, that is not to say that the second line of defence has no role to play in this area. In addition to identifying conduct risks within their own departments and functions, the second line of defence can play a valuable role in helping to identify read-across relating to conduct risks across business lines, products and jurisdictions. It can also play a role in tracking quantitative metrics on conduct risk to help identify emerging themes.
- **Effective training**: Most firms now provide conduct training that includes tailored scenarios. Completion of mandatory training may be tracked, but firms may be able to do more to assess the effectiveness of their conduct training programmes. For example, do firms observe employees more readily and proactively identifying conduct risks following training? Can employees articulate the key conduct risks that apply to their role, business area or function? How frequently do conduct risks that are identified in training crystallise? Feedback and learnings from each employee conduct training cycle on these questions should be collated and used to inform future training cycles. It may also be helpful to incorporate these learnings into other mandatory training modules in order to reinforce the message that conduct risk management is an ongoing activity and that it is not exclusive to one subject area. This kind of feedback should also feature in regular conduct risk management information for senior management in order to help inform a firm's wider conduct risk programme. As firms' approaches to identifying conduct risk evolve, so too should their communications to and training for employees on the topic.
- **Continuing the conversation about conduct risk**: Discussions about conduct risk should not stop at the end of training sessions or only take place when an issue arises. The FCA expects conduct risk to be a feature of day-to-day discussions among employees, including in non-transactional or parts of firms that are not client-facing. For example, firms should consider including conduct risk as a standing agenda item for relevant meetings and other informal channels as a means of encouraging employees to proactively escalate new conduct risks that they identify. Such discussions may benefit from a focus on emerging conduct risks, their relative impact on the business area in question and whether current controls are adequate to mitigate these risks. To help keep this type of conversation alive, firms may benefit from utilising frequent, bottom up, pulse surveys that asks employees to identify emerging risks within their area.

Remuneration and performance assessments

The FCA found that many firms have taken steps to ensure that personal conduct and behaviour is a 'prominent factor' in achieving objectives. However, more work needs to be done in order to ensure substantive and effective feedback loops.

The FCA's methodology

In order to compile its feedback, the FCA gathered information from 18 large wholesale banks and also hosted roundtables with some of those banks' employees. The employees who participated in these roundtables each had approximately 10 years of industry experience. Some of them had responsibility for the performance of other employees, but not necessarily responsibility for an entire team or business area. The FCA described this group of employees as '*the Engine Room*' on the basis that these employees are '*pivotal*' in terms of '*revenue generation, control [and] support infrastructure' and 'are often seen as emerging leaders for [their] firm[s]'*.

Remuneration was described by the FCA as '*one of the most influential drivers of behaviour*', warning that badly structured remuneration frameworks can 'encourage or create harmful consequences'. Remuneration arrangements can also positively influence approaches to diversity and inclusion. In order to assess the effectiveness of firms' remuneration frameworks and approaches to annual appraisals, the FCA requested information from 18 large wholesale banks. The information requested by the FCA included the number of employees who had their remuneration increased or decreased by more than 10% due to conduct or behavioural issues, as well as records relating to more significant changes that had been made to employees' remuneration. The information received by the FCA covered just over 55,000 employees. Although the statistical quality of information received from firms varied, only 750 (1.4%) of these employees had had their remuneration reduced by 10% or more due to conduct or behavioural issues.

The FCA noted that there continues to be significant differences in firms' approaches and levels of sophistication in deciding final remuneration outcomes. Although most firms have a formal remuneration framework, the FCA found that five of the 18 firms that they reviewed '*undermine[d] their process[es] by making totally ad hoc, isolated remuneration decisions*'.

Areas that firms should consider in light of the FCA's feedback are as follows:

– **Processes**: Most firms have processes in place that prompt them to consider whether any adjustments should be made to an employee's remuneration if that employee is found to have engaged in misconduct which has, for example, resulted in them going through a disciplinary process. These need to be applied consistently with transparency and objectivity in order for any adjustments to withstand challenge.

– **Feedback**: Firms should ensure that their performance assessment framework encourages '*focused and constructive feedback*' including about employees' conduct, which balances praise with areas for improvement. This feedback should not only focus on the 'what' (ie what results have been achieved) but also the 'how' (ie how those results have been achieved in terms of personal behaviour and conduct). Feedback relating to employee conduct should also be 'little and often' throughout the year, with feedback being collected for multiple sources on a 360 basis to ensure it is as thorough as possible.

– **Recognising good conduct**: We spend a lot of time thinking about what should happen to an employee's remuneration when they engage in misconduct or exhibit poor behaviours. Much less focus is placed on how firms should recognise and reward good conduct, but doing so is key. Non-financial rewards for good conduct should be ongoing throughout the year and can serve as an effective management tool.

– **Promotions**: Feedback received by the FCA indicated that only 15% of employees who participated in the FCA's roundtables felt that their firm's promotion criteria were clear, with many employees describing it as '*too opaque*'. Firms should ensure that their criteria for individual promotions are clear, as this can significantly impact how a firm is able to incentivise the next generation of leaders to act in accordance with its culture and values, and a lack of transparency may also impact on diversity initiatives. Such criteria must, however, be adhered to. Feedback received by the FCA indicated that employees feel concerned and annoyed when colleagues who exhibit poor behaviour are still promoted.

Remuneration Committees: Ensuring that direct or indirect responsibility for misconduct is adequately reflected in the remuneration of senior management is often difficult for Remuneration Committees. Earlier this year, **the FCA wrote** to the Chairs of Remuneration Committees to set out its latest findings and observations in relation to firms' remuneration arrangements. Key observations made by the FCA in this letter included that some firms are slow to conclude investigations into employees and are unable to demonstrate how they aligned levels of remuneration adjustment with the findings made about an employee's conduct. The FCA made it clear that they expect to see '*consistent and timely judgements*' in relation to remuneration adjustments made in these circumstances.

Safety, speak up and listen up

The FCA awarded most firms '*a pass for basic infrastructure*' in relation to their whistleblowing arrangements, but found that many firms have more work to do in order to embed healthy speak up cultures in their organisations. In particular, the FCA identified a persistent and significant lack of psychological safety within firms, which acts as a barrier to employees raising concerns.

Creating the right environment for employees to raise concerns is a challenge that all firms grapple with. However, this kind of environment cannot be built overnight. It is a long term objective and needs continuous attention from management through their communications and day-to-day actions (eg town halls and team meetings) to demonstrate their ability and willingness to listen and for employees to trust them.

The FCA set out a number of interesting insights and observations in relation to the effectiveness of firms' whistleblowing arrangements and the willingness of employees' to raise concerns. These insights and observations are based on the information that the FCA gathered from firms, as well as from their employees who participated in the FCA's roundtables:

- Most employees have a good understanding of their firms' whistleblowing arrangements, but they rarely feel the need to escalate concerns beyond their direct line manager.
- Only 44% of employees surveyed felt strongly that employees at all levels in their organisations were always able to raise concerns.
- Reasons provided by employees for being reluctant to raise concerns included a fear of reprisals, shyness and insecurity. The FCA also commented that '*culture[s] of perfectionism*' or '*zero tolerance for mistakes or errors*' can create '*a very unhealthy environment*' which discourages employees from speaking up. Some employees also expressed doubts as to whether they could trust HR, their line manager and/or third party channels when raising concerns.
- Employees explained that they find deciding whether to raise concerns more difficult in challenging cases. In particular, employees described experiencing 'higher levels of anxiety' when deciding whether to raise concerns that may be of '*borderline significance*' and concerns that may be outside of their immediate area of expertise. They also highlighted challenges when deciding to raise concerns if the impact of doing so is likely to be significant (eg if doing so may have immediate revenue implications) and if a concern needs to be raised urgently.
- More junior employees may find it harder to raise concerns, take longer to feel comfortable doing so and are likely to worry that their concerns may not be valid. They may also find it easier to raise concerns as a group, rather than individually.
- Line managers play a vital role in establishing an environment of psychological safety, which empowers employees to raise concerns.
- Employees typically view contacting HR or raising a concern through their firm's formal whistleblowing channel as a '*radical*' or '*nuclear*' option, which is '*unappealing*' and '*dangerous*' prospect.

Most firms will have already spent a considerable amount of time reviewing their whistleblowing arrangements. However, in light of the FCA's most recent feedback, firms should consider revisiting the following areas:

- **Training**: Dual-regulated firms are required to provide all employees with training about how employees can raise concerns and solo-regulated firms are strongly encouraged to do the same. In light of the FCA's feedback that more junior employees may find it harder to raise concerns, firms should ensure that they include whistleblowing training in their employee induction programmes. However, whistleblowing training should not end here. Employees should be provided with regular training and reminders about the importance of raising concerns through both formal and informal channels, as well as how they can do so.
- **Middle management**: Middle management act as a bridge between junior and senior employees. They can facilitate communication between those two groups, but can also act as 'blockers'. In its feedback, the FCA emphasised the impact that middle management can have on employees' willingness to raise concerns. As a result, firms should place appropriate focus on educating middle management about how they can go about creating an environment in which employees feel able to raise concerns, either with them or through other channels. Middle management should also receive training in order to help them recognise employee concerns that may be raised with them and require escalation to their firm's formal whistleblowing channel. This training should also cover how middle managers should handle these concerns sensitively and discreetly.

– **Providing clarity on formal whistleblowing channels, as well as informal 'speak-up' channels for raising concerns**: Reprisal remains front and centre of employees' minds when it comes to raising concerns, be it formal whistleblowing or day-to-day 'speak-up'. As a result, firms should ensure that they have clear communication strategies around how employees can raise concerns, so that employees understand the options for, and feel comfortable in, raising different types of concerns.

– **Triaging concerns**: The FCA's definition of 'reportable concern' for the purposes of its whistleblowing requirements is broad and, importantly, is broader than the employment law definition of the term under the Public Interest Disclosure Act 1998. For example, the FCA's definition of 'reportable concern' includes the breach of a firm's internal policy, even if that breach does not amount to a breach of law or regulation. Employees raise concerns covering a broad range of topics. Some of these concerns should dealt with in accordance with firms' whistleblowing processes. However, other concerns may be more suited to being dealt with through firms' grievance processes. It is sometimes challenging for firms to decide whether a concern raised by an employee should be dealt with through their whistleblowing or grievance processes and we are seeing more firms implementing formal triage processes in order to help in this area.

– **Feedback to employees who raise concerns**: In its feedback, the FCA said that employees '*need reassurance that escalated points are being listened to*' and that an 'absence of action or of regular updates' may discourage employees from raising concerns. Firms' whistleblowing policies typically require firms to provide regular updates to employees who raise concerns about the progress and outcomes of investigations. However, such updates tend to be quite limited. As a result, it is important for firms to manage employees' expectations about how much information will be shared with them about the progress and outcome of investigations into concerns that they have raised.

Culture and leadership

The FCA defined culture as '*the habitual mindsets and behaviours that characterise an organisation*', which is '*at the heart of how [the FCA] authorise and supervise firms, as well as where [it] may look for improvement*'.

The FCA acknowledged the progress that a number of firms have made in relation to their culture. For example, feedback received by the FCA indicated that '*[a]ggressive behaviour was being toned down*' and '*high performers*' were no longer protected from challenge or scrutiny. In addition, the FCA noted that some firms have designed specific award programmes to highlight and reward good culture.

For many years, the FCA has favoured the phrase 'tone from the top' to describe the impact that the values and behaviour of a firm's senior management has on the culture of a firm and its employees more generally. Most firms have embraced this concept and have taken steps to ensure that their senior management teams are more visible to employees around the world. However, the FCA received feedback that messages from senior management often not tailored to their target audience or jurisdiction. Where this was the case, the FCA found that these messages were viewed as less relevant and effective by employees.

The FCA highlighted the role of middle management in cascading key cultural messages within their teams, describing their role as '*hugely important*'. It is especially important that middle management play this kind of role in large international firms, where senior management may be more remote. However, even with numerous mechanisms for senior management to cascade information through firms, firms still often have difficulties ensuring that middle management are able to consistently and effectively communicate and role-model key messages. For example, feedback received by the FCA described messages relating to key cultural issues delivered by middle management as '*inconsistent*', '*less efficient*' and lacking in confidence.

This is problematic for firms, given that employees typically take their behavioural steers from their immediate line managers. Reasons for middle management struggling in this area can include bandwidth to give appropriate time and consideration to such issues, or even middle management skill-sets and experience – many managers are promoted because of revenues and performance, rather than being experienced in what management or leadership means in practice.

In light of the FCA's feedback on these points, firms should give thought to the following practical points:

– **Empowering middle management**: Very often, middle management are 'time poor' and have limited capacity to communicate effectively the key messages conveyed by senior management. This population typically benefits from having clear understanding of what they are empowered to do with regards to conduct risk, in terms of expectations from senior management and the tools they can use at their discretion.

– **Adjusting tone from the top**: There is often a need for the 'tone from the top' to be adjusted to each layer of a firm, recognising the different dynamics in terms of relationship between middle management and senior leadership downwards. The overarching message may be the same, but the way the message is conveyed and acted upon are two different things, depending on the role and seniority of the individual. Middle management should be given access to tools to make the messaging relevant and accessible. Focussed training can help in this area, enabling middle management to understand conduct broadly, why it matters and its impact in practice, and therefore adapt messages appropriately but consistently within the context of their teams. A similar point applies to firms with a presence across multiple jurisdictions, where 'tone from the top' messages may need to be adjusted to appropriately reflect any regional differences.

Purpose, principles and values

The FCA found that many employees are confused about their firm's corporate purpose statements and how such statements link to their own roles and responsibilities. For example, the FCA found that many employees mistook statements made by senior management about standards of behaviour as de facto corporate purposes.

Last year, the FCA started to use the term 'tone from above' in recognition of the influence that employees who sit below senior management level can have on culture. This year, the FCA introduced the term 'tone from within', describing it as '*an important new operative phrase*' which represents a person's '*mindset, preferences, beliefs, habits and pre-dispositions*'.

The FCA's evolution of 'tone' does not equate to a revolution in the way that firms approach conduct risk. The 'tone from the top' was always intended to influence and inform the conduct of every employee within a firm. However, the 'tone from within' sends a stronger message to employees about the onus on them to challenge their own biases, behaviours and habits in the conduct of business. Individuals tend to attribute a higher sense of integrity to themselves, which may be leveraged in order to cultivate a 'tone from within' with the right input from senior management and the right incentives. The challenge for firms is in developing the tools to encourage this behaviour across a firm in a meaningful and sustainable way.

In light of the FCA's feedback and introduction of the concept 'tone from within', firms should consider the following points:

- **Clarify**: A firm's purpose, principles and values should be simple and consistent. They should also resonate with and make sense to a firm's employees. Firms that are considering re-working their corporate purpose should consider engaging employees in that process.
- **Communications**: Firms need to ensure that their corporate purposes are cascaded effectively to all employees. Line managers have a key role to play in this area, as they will be able to bring their firm's corporate purpose to life for employees in their teams, with reference to their roles and responsibilities.
- **Link to strategy**: Where a firm's strategy is clearly underpinned by its corporate purpose and values, this may help to reinforce employees' understanding of this purpose and these values on a day-to-day basis. If employee behaviours and actions are directed in a way which is consistent with the firm's business strategy, then such behaviours and actions will re-affirm their awareness and understanding of the firm's corporate purpose and values.

Leveraging the 'tone from within': Firms should consider designing conduct risk training which requires employees to reflect on whether their assessment of conduct risk and how they would react in a particular situation changes depending on whether they are acting alone or as part of a team/group. Training should include a narrative regarding personal responsibility for employee actions.

Next steps

Thoughts for consideration highlighted by the FCA

In its feedback, the FCA highlighted the following points for consideration by firms in relation to their conduct programmes:

1. Have staff had sufficient training to be able to identify conduct risk in their day-to-day roles beyond general awareness?
2. Does the firm's overall framework for identifying and mitigating conduct risk reflect adequate, bottom-up exercises to understand those risks?
3. Do staff understand how their own roles and responsibilities can potentially create conduct risk or harm for the customers, the firm or markets?
4. Are messages from the top, including corporate purpose and values, translated in a meaningful way to the specific roles and responsibilities, targets and objectives at the individual and unit level across the firm?
5. Is enough being done to support line managers in their efforts to enable their teams to perform at their best?

Culture and governance remain priority areas for the FCA. The FCA reminded firms of '*their clear regulatory obligations around culture and conduct*' and of the importance of infrastructure and training initiatives going beyond policy and process. In addition to helping to avoid harm, the FCA has also encouraged firms to think about improving their approaches to conduct risk as being '*good for business*'.

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