

## REGULATORY INTELLIGENCE

## The 'S' in ESG: UK regulators consider major new diversity and inclusion requirements

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UK regulators' [joint discussion paper](#) on driving change in diversity and inclusion holds many surprises, but its appearance is not one. Diversity is a regulatory priority and the [Regulatory Initiatives Grid](#) scheduled [DP21/2](#)'s publication for this summer, alongside an action timeline culminating in an autumn 2022 policy statement. Its radical proposals could be rules comparatively soon but some firms face extra work within months.

[DP21/2](#) was drafted by the Financial Conduct Authority (FCA), Prudential Regulation Authority (PRA) and Bank of England. The [Regulatory Initiatives Grid](#) described [DP21/2](#) as 'moving the dial' and its proposals certainly make the current UK diversity regime seem comparatively meek.

Firms' core obligations stem from the [Fourth Capital Requirements Directive](#) (CRD IV) and revised [Markets in Financial Instruments Directive](#) (MiFID II). They must have a board appointments diversity policy; those with nomination committees must set a representation target for the under-represented gender, meaning women. The Fifth Capital Requirements Directive (CRD V) added a requirement for gender neutral remuneration policies.

### Slow progress

UK legislation requires firms with over 249 employees to report their gender pay gap annually. Despite repeated FCA scoldings about improving diversity to improve cultures, other measures are either 'comply or explain' like the [Corporate Governance Code](#) for listed firms or government-endorsed voluntary programmes, like the Women in Finance Charter. Most concentrate on boardroom gender representation.

Even progress on female senior appointments has slowed and things could be slipping backwards for some racial minorities. Regulators, which have an [Equality Act 2010](#) statutory duty to eliminate discrimination and advance equal opportunities, intend to get the sector running forward.

[DP21/2](#) sketches out a wide-ranging regime for accelerating reform. Subject to proportionality, its proposals would apply to all firms regulated by the three authorial bodies. They cover appointments at and several levels below board level, individual accountability, remuneration, 'fit and proper' assessments, reporting and disclosure.

### Cognitive diversity

These propositions are considered in more detail below but the definitions of diversity and inclusion [DP21/2](#) uses raise some questions. By diversity, the regulators mean diversity of thought, taking it beyond the Equality Act's nine protected characteristics. Those characteristics are age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion, sex, and sexual orientation.

Diversity of thought is given a broad definition: 'bringing together a range of different styles of thinking among members of a group. Factors that could lead to diverse thinking could include, but not limited to, different perspectives, abilities, knowledge, attitudes, information styles, and demographic characteristics, or any combination of these.'

Sumitra Subramanian, a principal associate in Eversheds Sutherland's financial services disputes and investigations practice, said this definition reflected regulatory thinking on the need to avoid groupthink but was hard to pin down.

"How might different perspectives, knowledge, attitudes or information styles be measured or demonstrated?" Subramanian said. "[DP21/2](#) goes on to state [at 1.15] that diversity of thought can be affected by many factors, including the nine protected characteristics but can also include other factors. It would be useful to know what other factors might be considered.

"The fluidity of the definition may prove problematic. Having said that, at this stage it's difficult to see how the regulators could narrow the definition without undermining their policy objectives."

It would be a bold firm that argued mixing Keynesian and Hayekian economists constituted improving diversity, however. Unlike earlier initiatives, [DP21/2](#) views diversity and inclusion as intertwined and equally important as 'an inclusive culture is... necessary to enable the benefits of diversity of thought to flourish.'



DP21/2 says 'psychological safety,' often called a 'speak up' culture, is essential for fostering inclusion, which it defines as 'the practice or policy of providing equal access to opportunities and resources for people who might otherwise be excluded or marginalised, for example due to demographic characteristics.'

That alludes to the [nine protected characteristics](#), but again could encompass other factors that are hard to identify, let alone quantify. The regulators concede that inclusion is harder to achieve and measure than diversity. That difficulty and the broad definitions mean that, as things stand, there is a risk the initiative could degenerate into a kind of regulatory sniff test, particularly in sensitive areas like representation targets for appointments.

DP21/2's main proposals are in chapter 5 and outlined below. Measures requiring rule or guidance changes are scattered throughout chapter 5 so paragraph numbers are given for assistance.

### **Representation targets**

On board appointments, paragraph 5.16 moots extending the [CRD IV](#) 'under-represented gender' target requirement to a wider range of firms and characteristics. The FCA is also investigating a 'comply or explain' requirement for listed firms to have at least two diverse directors, as proposed by NASDAQ. Diverse boards grow from diverse talent. Paragraph 5.18 proposes making it explicit, in either rules or guidance, that diversity be among the succession planning and collective board suitability considerations when contemplating appointments.

Firms could be required to set targets for appointing under-represented groups to the wider senior management population (5.41-5.46). This would involve adopting a common definition of 'senior management.' For large firms, this should cover the board and two leadership levels below (5.38). Targets are also suggested for customer-facing roles, especially those certified under the Senior Managers and Certification Regime (SMCR), and perhaps across the wider firm (5.42).

'Where targets are used, they should be stretching enough, with a defined timeframe, to contribute towards meaningful change. Progress against diversity targets and other metrics should lay the foundations for actionable next steps and guide the direction of future diversity and inclusion initiatives,' stated paragraph 5.44.

Regulatory diversity targets covering many characteristics and several organisational tiers would be quite a change, even if they are an expectation not a requirement. So would proposals to use SMCR to make senior managers individually accountable for diversity and inclusion and to use diversity and inclusion criteria in 'fit and proper person' assessments of individuals and firms.

### **Individual accountability**

Individual accountability (5.20-5.26) would be introduced at dual-regulated firms by making it explicit that prescribed responsibilities PR(H) and PR(I), which cover responsibility for culture, include diversity and inclusion. This would include responsibility for measures arising from DP21/2. For solo-regulated firms, to which the culture prescribed responsibilities do not apply, responsibility would attach to the holder of an existing senior management function.

The regulators would like the variable remuneration of the accountable individual and all senior managers responsible for managing employees to reflect their performance against diversity and inclusion objectives (5.30). Ahead of that, they are considering developing guidance on how relevant metrics can be included in non-financial criteria used when setting variable awards.

### **Fit and proper individuals**

The regulators are exploring whether someone's adverse conduct regarding diversity and inclusion issues could affect their 'fit and proper' assessment (5.69). As part of this, they may develop non-financial misconduct guidance (5.70), plus guidance on how bad behaviour concerning another's characteristics can breach the conduct rules [COCON 2.1](#) and [2.2](#).

"For some time, the FCA has been suggesting that there could be a link between diversity and inclusion, under the umbrella of 'non-financial misconduct,' and fitness and propriety," said Sophie White, an employment partner at Eversheds Sutherland.

"Formalising this would, however, represent a major shift in the regulators' current position. Current guidance [ [FIT 2.1.1](#) ] is that when assessing fitness and propriety, the FCA will only consider matters 'relevant to the requirements and standards of the regulatory system.'"

### **Fit and proper SMFs and firms**

To increase scrutiny of senior managerial diversity, the regulators are considering collecting data on individuals applying for approval to hold senior management functions (SMFs). Where an appointment 'would worsen or not address' risks arising from insufficient diversity, the application would be discussed with the firm (5.71). Senior management diversity, and any discriminatory activity, would be considered when assessing whether firms are 'fit and proper' under the [Financial Services and Markets Act 2000](#) Threshold Conditions. Guidance on this may be developed (5.73-5.74).

### **Metrics reporting and disclosure**

Information will be essential in determining firms' diversity and the impact of policies and regulatory developments. Firms are advised to conduct diversity and inclusion audits (5.65-5.67) and the regulators may require them to disclose diversity data on their senior management and workforce as a whole, along with their diversity and inclusion policies (5.57).



The main proposals are in chapter 4, however. Firms would be required to report regularly on diversity and inclusion (4.2 and 4.17-4.22) and be expected to develop metrics that enable initiatives to be monitored effectively (4.8). Appendix 2 outlines an approach to metrics for firms to consider.

#### **Pilot data survey**

To help develop DP21/2's policy proposals and test firms' ability to provide relevant statistics, the regulators will run a one-off, voluntary [pilot data survey](#) covering a representative sample of solo-regulated firms and all dual-regulated ones. (4.7 and 4.10-4.16). This will use aggregated and anonymised data firms already hold and concentrate on the protected characteristics and socio-economic background. The pilot starts this autumn so firms may want to start preparing.

[Complaints Procedure](#)

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