7. Stop Bad Apples from Rolling

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Introduction

11-year prison sentence, 5-year professional ban from the industry, forfeiture of compensation and requirement to repay bonuses – sanctions against individual employees of a corporation have become a reality. But does it stop there?

On the back of various scandals and investigations in the financial industry over the last decade, regulators and prosecutors around the globe have increasingly focused on the behavior of employees. Financial penalties against companies are no longer accepted as a cost of doing business; rather, individual responsibility, including fines, professional bans and even imprisonment, has become a reality. Regulators are increasing their efforts to identify bad actors – both regarding their own actions or lack of supervision – and to implement measures preventing them from continuing to work in the financial industry. Part of that effort is identifying employees who engaged in misconduct at one firm and preventing them from spreading that misbehavior at a new employer – stopping the bad apples from rolling.

Whilst we see increased focus on individuals, one key challenge is the diverse landscape of laws and regulations. Various countries have different rules, and there is not one consistent framework that tackles the problem globally. The lack of coordination does not only lead to a piling on of the problem; it also encourages individuals to engage in jurisdictional arbitrage. The rules are distinctly different in various jurisdictions, but the dilemmas remain the same. Conceptually, the responsibilities of regulators and employers need to be clarified. It seems logical that the onus of ensuring a clean market cannot stop with the employer but must extend to the appropriate supervisory and enforcement authorities.

This article aims to provide a high-level overview of current and planned regulation in Switzerland, the US and the UK and to identify the key pressure points that will help stop bad apples from rolling.

Switzerland

With few exceptions, Switzerland does not have registration requirements for employees in the financial industry. Financial organizations do, however, have to report gross misconduct of senior employees to FINMA. FINMA keeps a “watch list” which is based on the concept of ensuring proper business conduct of the financial organization and is confined to the most senior employees of companies; mainly those involved in the strategic or executive management of the company.

The proposed Financial Services Act suggests a registration requirement for client advisors in the financial industry that includes both proper qualification as well as the absence of a criminal record with respect to financial crimes and a professional ban issued by FINMA. The proposal has two important restrictions: (1) it only applies to certain employees, i.e. client advisors; and (2) it is limited to a circumscribed list of misbehavior, namely criminal records of relevant financial crimes or a professional ban. In turn, it would not apply to employees who have displayed misbehavior that was either not relevant (e.g. criminal conviction for “non-financial” crimes) or behavior that led to sanction below the level of a professional ban, such as internal disciplinary measures like written warnings.

The current lack of registration requirements in Switzerland is, to some extent, countered by the concept of reference letters. Under the Swiss Code of Obligations, companies, as part of their duty of care towards employees, have to provide employees with a reference letter that includes an assessment of the employee’s behavior. One of the pressure points of reference letters is the dilemma between “truth” and “benevolence,” and companies often err on the side of benevolence to avoid difficult discussions and disputes with employees where in fact a more truthful and open disclosure of misbehavior would be appropriate. The very fact that employers shy away from being more open and truthful in providing references enables employees to find new roles in the industry and prevents future employers from learning about the misconduct of the candidate.

USA

The US has a distinctly different approach. Reference letters are far less common (and also are not required by law), largely on the basis that companies do not want to be exposed to defamation claims by employees or future employers for what has been stated in reference letters. In turn, the US has a far more detailed system of registration requirements and information that has to be provided to regulators regarding disciplinary measures and exits of employees who conduct “regulated activities”. Importantly, the registry is publicly accessible so that new employers can vet candidates. More recently, we have seen two conflicting developments in the US: whilst the Department of Justice is advocating a higher focus on identifying individual wrongdoers and holding them responsible (“Yates Memorandum” of September 2015), various states are enacting legislation prohibiting employers from asking applicants about their past criminal record in an effort to improve the job prospects for ex-offenders (“ban the box”).

UK

Somewhat between the US and Switzerland, employers in the UK do provide reference letters to employees, but not in as much detail as in Switzerland. However, as a result of recent regulatory change, there is an increased focus on references provided between organizations, resulting in the UK regulators requiring a more robust reference system.

The recently established Senior Managers & Certification Regime (SM&CR) has overhauled the UK regulatory system and placed responsibility on firms to be accountable for their own actions and those of their employees, based on the regulators’ view that a firm knows its employees better than the regulator. As part of this, the PRA/FCA issued a consultation paper on “regulated references”, which envisions a pro-forma reference to strengthen accountability and prevent individuals who have engaged in misconduct and regulatory breaches from moving between firms that remain unaware of the behavior and ensure a consistent approach in the information provided between firms. The proposal requires banks to take reasonable steps to obtain references from former employers in the last six years, and, when providing references, to disclose certain conduct

and disciplinary action arising in the last six years (such action may also be disclosed to the regulator). An updated reference will be required if, in the six years after providing a reference, issues come to light that impact fitness and propriety and, if known at the time, would have been included in the reference. The proposed rules apply to selected individuals who are considered senior managers under SM&CR, certified employees under the certification regime and non-executive directors.

A consultation paper on "buy-outs" and preventing employees from "washing" their stock by moving from firm to firm is a further example of the UK regulators focusing on stopping bad apples from rolling.

Pressure Points

a. Responsibility Between Authorities and Companies

One key pressure point is the responsibility to stop bad apples from rolling. What is the role of regulators or enforcement agencies and what is the role of companies? Currently, we see a mix between responsibility for firms through references they provide to each other or reports they have to file with regulators and the registration requirements by regulators, which in some countries include the power of the regulator to prevent employees from taking on a new role. Switzerland is a good example of this mix as it captures egregious misconduct by senior employees through the FINMA watch list but otherwise relies on the concept of reference letters. Whereas in Switzerland reference letters often have a bias towards benign wording and a shift towards more open and honest references would be warranted, other jurisdictions should introduce the concept of reference letters even if it means accepting civil liability vis-à-vis the employee where appropriate for the benefit of the market. We see this tendency in the UK, where the proposed rules shift the responsibility from regulators to companies by requiring companies to provide each other with consistent information in "regulated references" whilst the regulators will no longer house registration information.

- An effective concept is not a question of either/or but rather requires responsibility of both the authorities and companies. It will only work if companies embed it into their DNA and are open and candid towards regulators and future employers. In turn, regulators have to provide adequate (and consistent!) guidance or rules to companies to (1) ensure consistency of information; and (2) encourage companies to be transparent in disclosing misconduct in the face of the threat of a defamation or stigmatization claim by the employee. Also, courts play a critical role when deciding in defamation claims where the employer has done the right thing for the benefit of the market and other potential employers.

b. Multidimensional Complexity (Different Industries, Different Jurisdictions)

Employee (mis)conduct has been largely discussed in the context of the financial industry in the last couple of years. However, as evidenced by the more recent scandals in the automobile industry and sport associations, the problem is not confined to one industry and employees are obviously not bound to a particular industry.

Another important dimension is the geographical diversity. The increased mobility of employees necessitates a coherent approach. Otherwise, the problem will simply be shifted from one country to another.

- First, it is not sufficient to only have rules by financial regulators; the concept should be adopted by other regulators or – more generally – become part of broader employment laws. Second, within industries regulators, enforcement agencies and associations need to coordinate the concept so as to have a consistent approach globally.

c. What is a Bad Apple?

Another key pressure point is the tension between the public's interest in proper practices in the financial industry on one hand, and the employee's interest in not being completely banned from the industry for relatively minor misconduct or being disproportionately impacted for his or her entire professional career on the other.

Related questions are: what behaviors should be considered and for whom it should be relevant? A desired outcome, e.g. a professional ban for one industry, may lead to overly severe impact on the employee and – more broadly speaking – have an unwanted impact on "re-socializing" individuals. Certain conduct or even criminal convictions that are relevant in one industry or profession may not be applicable to another industry. Moreover, in some countries such as Switzerland or Germany a good reference letter is pivotal in the hiring process and for the employee's future career.

Even more important is the question of the degree of severity of misconduct that requires filing with regulators or making disclosures to future employers. Not every act of misconduct leading to minor disciplinary measures should require notification. Where a company decides to issue a warning to the employee but decides to continue to employ him or her, it thereby signals that the employee deserves a second chance. Consequently, the employee should not be stigmatized, as such a label may lead to a severe impact on his or her career. Where, on the other hand, the employee is dismissed or chooses to leave the firm under the cloud of an ongoing investigation, it becomes important that future employers are able to make an informed decision.

Finally, it is also relevant to consider the level of seniority of employees or the roles they have in a firm. More senior employees and employees in more exposed roles with higher impact on risks should be held to higher standards.

- In order to find the right balance between the interest of the financial market as such and the employee's interests, regulators and companies need a framework defining what conduct and which employees require disclosure to regulators or future employers. Without a clearly-defined framework, companies will have to apply their own judgment when dealing with misconduct thereby perpetuating the diverse landscape and preventing a consistent approach.

Conclusion

The problem of stopping bad apples from rolling is one that has to be addressed by regulators, enforcement agencies, and employers, and ultimately supported by courts when deciding claims by individuals. Even with increased or better coordination amongst authorities, employers will have a responsibility to balance the interest of the industry against the duty of care and the interests of the employee. That includes bolder decisions by employers to "do the right thing" and accept potential liability against employees where a more open and transparent disclosure of misconduct serves the financial markets. However, it is equally important that regulators and enforcement agencies contribute to the solution of the problem by providing and enforcing – globally – coordinated and consistent rules.

About the author:

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