CP17/25: Individual accountability - extending the Senior Managers and Certification Regime ("SM&CR") to all FCA firms ("the Consultation Paper")

Simmons & Simmons LLP - Response on behalf of clients

1. Introduction

1.1 Simmons & Simmons LLP ("**Simmons & Simmons**") has considered the legal and regulatory issues raised by the Consultation Paper. Following this, we have discussed the Consultation Paper with a large number of FCA regulated clients and contacts across the financial services industry. This response takes into account a range of views put forward in respect of some of the specific questions asked in the Consultation Paper and the SM&CR in general. It reflects our own perspective as advisors as well as that of a number of our clients in general. It is not attributable to or to be taken as the position of any individual client of Simmons & Simmons. Where we have not responded to a specific question asked in the Consultation Paper, neither we nor our clients had any comments.

1.2 We have included at Appendix 1 a copy of Simmons & Simmons' response to the Discussion Paper DP 16/4.

1.3 We have included at Appendix 2 a copy of Simmons & Simmons' response to the Final Report MS15/2.3 and Consultation Paper CP17/18.

2. General Comments

2.1 Our clients appreciate the challenges faced by the FCA in extending the SM&CR given the breadth and diversity of the firms that it covers. They welcome the opportunity to provide their views on the new regime. Our clients take comfort from the fact that there is a substantial amount of experience already in the industry from banks, which have implemented the regime already. Whilst for some of our clients the implementation will not be without challenges, many see this as an opportunity to put in place processes which will assist them to improve or clarify existing governance arrangements and processes. The general feedback we received from our clients on the Consultation Paper was positive. Clients found the Consultation Paper to be clear and appreciated the use of diagrams and route maps. Our clients are looking forward to the technical consultation paper to be published by the FCA later this year which will set out the FCA's proposed steps for firms to move from APR to the SM&CR.

2.2 We understand that the extended SM&CR is likely to be applied to solo-regulated firms from late 2018/beginning of 2019. As the FCA will understand, our clients wish to be able to implement SM&CR with the benefit of as much certainty as possible about its structure and details. They are conscious that the FCA is still assessing the implementation of the SM&CR by banks and that it is providing feedback to the industry on that. In addition, the FCA has not yet consulted on the position of General Counsel following its discussion paper last year. A number of clients therefore suggest that delaying implementation further into 2019 would be beneficial. We hope that the FCA will be able to reiterate these concerns to the Treasury.

2.3 In order to reflect their existing performance appraisal processes, they also suggest that there be a transitional period to allow firms to align the certification process with existing internal processes (i.e. if the extended SM&CR generally were to come into effect in March 2019, firms should not be required to certify significant harm function staff until March 2020). This is in line with the approach which applied to banks. We trust that details on transitional provisions will be addressed in the FCA's technical consultation paper and will respond in more detail on this point at that time.

3. **Question 1 - Does the proposed list of Senior Managers in the core regime cover the appropriate roles, i.e. the most senior decision makers within a firm?**

3.1 Subject to our comment at question 2 below, our clients were generally content that the list of Senior Managers in the core regime covered appropriate and relevant roles. They appreciate the fact that the regime is not seeking to change how firms organise themselves but that the overall aim is to ensure that individuals within the firm are clear about the structure and allocation of responsibilities.

3.2 In relation to firms which take the form of partnerships or LLPs, there is one point on which additional clarity is sought. Given that it does not seem possible to apply individual accountability to a corporate, clients should be grateful for the FCA's confirmation that corporate members of LLPs cannot be senior managers.

4. **Question 2 - Are there any other roles that the FCA should consider specifying as SMFs? (You may wish to consider the list of proposed Senior Managers under the enhanced regime in section 8.16)**

4.1 Our clients agree with the FCA's approach to a proportionate application of the senior manager aspects of the regime to core firms. In particular, they agree that there should be a more limited number of senior managers in core firms and that core firms should not be required to assign "other overall responsibilities" SMF 18 functions in the same way as enhanced firms. However, a number of clients, which are likely to fall within the core regime, expressed a wish to have the flexibility to introduce, if they wish to do so, an additional Senior Manager Function where appropriate based on the structure of the firm to a person who is not a director or partner. For example, some clients felt that a SMF24 role (such as a Chief Investment Officer, Chief Operating Officer and/or Chief Technology Officer) *may* be appropriate for their structures where particular overall responsibilities are not held by a director or partner. This additional SMF will not be appropriate or necessary for all firms within the core regime and should be an option only.

5. **Question 3 - Are there any proposed Senior Managers that the FCA should consider excluding from the core regime?**

5.1 Although there has not been a direct question on this point in the Consultation Paper, many of our clients wish to take the opportunity to note (as we pointed out in our response to the FCA's discussion paper on this matter at Appendix 1) that the General Counsel should not, in their view, be a Senior Manager under the SM&CR. Amongst clients who will be covered by the extended SM&CR, there is a real concern that this will create a conflict between that person's legal obligation to the Board and to the FCA.

6. **Question 5 - Do you agree with our proposed list of Prescribed Responsibilities? If not, please explain why.**

6.1 A number of clients expressed concern that the list of prescribed responsibilities is generally narrow in scope and likely to fall largely on compliance and the CEO function. They would welcome guidance that it is open to core firms to allocate prescribed responsibilities more broadly across their senior managers if the responsibilities are genuinely allocated in that way.

6.2 Some of our clients have asked for some clarity in relation to PR6:

> "*Responsibility for ensuring the governing body is informed of its legal and regulatory obligations*"

6.3 Whilst we recognise that this is a prescribed responsibility applicable to banks, it is extremely broad in scope in the context of an organisation which has been identified as a core firm. This Prescribed Responsibility does not apply to enhanced firms and the responsibilities that apply to enhanced firms in table 8.19 of the Consultation Paper are more specific and narrower. In the context of core firms (which are by definition smaller and pose less risk of harm to consumers or impact upon market integrity), it is suggested that PR6 is too broad and should be deleted.

6.4 See response to question 6 below for comments on proposed PR7 in relation to value for money.

6.5 It is suggested in the Consultation Paper that SMF9 should be a Non-Executive position (Table 1 at 4.12), however we understand that the FCA is not suggesting that firms which do not currently have Non-Executive Directors should be required to introduce this role. Our clients would welcome confirmation on this point.

7. **Question 6 – Do you agree with our proposed Prescribed Responsibility for AFMs as set out in CP17/18? If not, please explain why?**

7.1 We consider that the current articulation of this prescribed responsibility (acting in investors best interests) in CP17/25 is at odds with the existing regulatory framework which currently includes corporate duties to:

(A) act in accordance with the best interests of clients – COBS;

(B) act in the best interests of Unitholders – COLL;

(C) pay due regard to the interest of its customers – Principle 6.

7.2 Our clients would welcome clarity from the FCA on the scope of this prescribed responsibility and an opportunity to comment on this prescribed responsibility in more detail, as this consultation process develops.

<u>Who will hold this prescribed responsibility?</u>

7.3 There appears to be a number of inconsistencies between CP17/18 and the Consultation Paper in respect of who would be the appropriate person to hold this prescribed responsibility.

7.4 CP17/18 states that this prescribed responsibility *"should be allocated to the chair of the AFM board, who will be a Senior Manager under the new regime" [footnote paragraph 3.35]*. However this specific direction is not repeated in the Consultation Paper which appears to provide core firms with flexibility to allocate this responsibility *"to the Senior Manager who is most responsible for that issue"*. Our clients would seek clarification from the FCA on the following:

(A) should this prescribed responsibility only be allocated to the chair of the AFM board?

(B) does this amount to a new Senior Manager role as per CP17/18? If so, should this be taken to amount to the SMF9 role in respect of authorised fund managers?

7.5 CP17/18 appears to contemplate that the role of the chair of the AFM board could be either an executive or non-executive role. However the Consultation Paper appears to envisage that the chair of an authorised fund manager would be a non-executive role.

Please see our response above to question 5 insofar as our clients welcome clarification that the FCA does not expect firms who do not have non-executive chairs to appoint non-executives.

The Value for Money assessment

7.6 Whilst our clients understand and support the FCA's customer protection agenda, they have expressed concern that the introduction of the duty to assess whether value for money has been delivered (on the current specific and granular basis), is less than straightforward in circumstances where this remedy is intended to strengthen an underlying duty which the FCA recognise is only implicit.

7.7 Our clients consider that assessing Value for Money by reference to "good" or "poor" creates a disproportionate expectation that Value for Money is measurable in absolute terms. It will lead to assessments with the benefit of hindsight, which will fuel unreasonable expectations amongst investors and will create significant legal and regulatory risk for fund managers when reporting to investors.

7.8 These tensions become even more marked when the FCA intend to include a new prescribed responsibility for *"an AFM's value for money assessments"*. Our clients are concerned to ensure that the scope of the Value for Money assessment rule and the prescribed responsibility connected to this rule is articulated in a clear and proportionate way.

7.9 Our clients are concerned that this senior manager will be unable to effectively discharge an obligation to assess whether "good" or "poor" Value for Money has been delivered, as a matter of fact. We would urge the FCA to move the focus of this responsibility (and the corresponding COLL rules) to the "how"; what steps the firm has taken to assess Value for Money; what framework is in place to assess Value for Money; and what framework is in place to enable the AFM board (and the chair in discharge of this prescribed responsibility) to discharge the duty to assess Value for Money. This would be better aligned with the existing corporate duties of directors and would avoid the imposition of a more onerous duty on this Senior Manager.

7.10 Further and in any event, in circumstances where this prescribed responsibility will require an ongoing assessment of Value for Money and at least annual reporting to investors, we consider that is unlikely in real terms that this role would be suitable for a non-executive. Our clients consider that the level of industry expertise, business knowledge and responsibility this role will require will mean that this senior manager will need to have a detailed and deep knowledge of the business. For more general comments about the scope of the proposed report on Value for Money, please see our response to CP17/18 at Appendix 2.

8. **Question 7 - Do you agree with the functions we have proposed making Certification Functions? If not, please explain why.**

8.1 Some clients are concerned that given different thresholds for the status of Material Risk Taker within firms (i.e. CRD, UCITS, AIFMD), to identify material risk takers for 3 different remuneration regimes as certification staff may be unworkable in practice. Our clients seek a mechanism to avoid individuals moving in and out of certified status from year to year – particularly if the reason for being caught as a Material Risk Taker relates to changes in pay rather than changes to the individual's role.

8.2 In the context of the FCA's extended regime, we do not think it is necessary to catch Material Risk Takers as a separate category of certification staff – individuals who pose the risk of causing significant harm are caught by the other categories. If the FCA is minded to retain this category, we would suggest that firms are not required to issue a certificate until their own next certification annual process after an individual has been identified as a Material Risk Taker. Some clients have suggested that non-executive directors who are classified as material risk takers due to their board role should expressly be taken out of the Certification Regime.

Extension of the CF30/client dealing function definition

8.3 Our clients have concerns that the scope of the client dealing function (i.e. extension of the CF30 role) is too broad and captures a significant number of individuals who do not pose a risk of significant harm to either the UK legal entity or to its UK clients and/or counterparties.

8.4 In particular, the extension of the definition of "dealing" brought in by the banking SM&CR is extremely broad and it is not, in our view, proportionate to apply it in the same way to non-bank firms in particular in an asset management context. Instead, we believe that (a) only those individuals who are based in, and operating out of, the UK legal entity and are carrying out the activities comprising the client-dealing function should be captured by this function (either for all firms generally subject to the extension or alternatively only those firms who will be subject to the core regime) and (b) the client dealing certification function should be limited to the current CF30 definition applicable to such firms (i.e. only to those who are properly dealing with UK clients under the current definition). To confirm, our clients consider that the current CF30 definition is set at the right level and ask that the client dealing function be aligned with the current test so that no additional individuals are caught.

9. **Question 9 - Do you think the identity of people performing Certification Functions should be made public by firms? If so, which Certification Functions should be made public?**

9.1 We have had a range of responses from our clients in relation to this matter. A common theme is that firms do **not** think that it would be helpful for firms to publish their own lists of certification functions and do not support this proposal. Lists held by firms would be fragmented, difficult to search/access, potentially inconsistent and of limited value to employers or customers.

9.2 However, as the FCA is aware, a number of firms are concerned at the loss of the approved person register on the FCA website. In particular, they consider that retail customers (and employees who deal with retail customers) rely on the FCA having approved individuals with the benefit of full information about their history.

9.3 In the absence of a regime whereby such individuals are approved by the FCA, a number of our clients suggest that the FCA could maintain a central register of those who have been certified by firms under the certification regime. To reduce the burden of maintaining the list, this list would only need to encompass those under the regime who are carrying out a client dealing function (or even the subset of individuals who are currently CF30). The list could be updated annually by firms following their internal certification process (with the date of certification recorded on the register).

9.4 If the FCA is unable to maintain this list, some clients have suggested that an alternative solution could be a list maintained by an industry body.

9.5 Whilst a number of organisations supported the above suggestions, a number of clients expressed a different view. They do not see value in publishing lists of staff conducting Certification Functions due to the limited value in such a list (as compared to the current register which denotes approval by the FCA). They also consider that keeping such a list up to date would involve unnecessary administrative burden.

9.6 Another point raised by some clients was that any list of Certification Functions should not include those identified as Material Risk Takers for remuneration purposes because this population is not relevant from an outside perspective unless the individuals concerned are also client facing.

10. **Question 10 – Do you agree with our proposed territorial limitation for the Certification Regime? If not, please explain why.**

10.1 In respect of their overseas staff, a number of our clients have found it difficult to apply the (i) general territorial test in the certification regime (set out in SYSC 27.3.1R) and (ii) as an overlay, the narrower test for what comprises the client dealing certification function (SYSC 27.7.21G). We would appreciate clarity that any person based outside the UK and dealing with UK clients should only be caught if they meet the client dealing certification function test. In other words, there should not be a wider test applicable to those in performing a different certification function (e.g. manager of a certification function). As such, for example, a manager of a certified function, who is based outside the UK and who does not perform the client dealing certification function would not need to be certified.

11. **Question 15 – Do you agree with our proposal to apply the Conduct Rules to financial services activities?**

11.1 Although our clients generally agree with applying conduct rules to financial services activities, there has been an interest in more clarity. Under paragraph 7.10 of the Consultation Paper our clients would welcome some examples of regulated financial services activities, unregulated financial services activities and related ancillary activities:

> "*7.10 We propose applying the Conduct Rules to a firm's regulated and unregulated financial services activities (including any related ancillary activities). For example, an activity carried on in connection with a regulated activity.*"

12. **Question 20 - Do you agree with our proposed approach of using the objective criteria set out above to identify firms for the enhanced regime? If not, please explain why and propose alternative approaches.**

Insurance intermediaries:

12.1 As regards insurance intermediaries, the test which seems most likely to apply to these types of firms will be the intermediary regulated business revenue threshold of £35m or more per annum. However this has not been confirmed by the FCA and our clients would welcome some clarity on this point. In particular, our clients would welcome clarification, given that the current test used is the revenue threshold of £35m or more relating to retail premiums, if and how this test will apply to commercial brokers.

12.2 It is currently envisaged that approximately 75 intermediary firms will be designated as enhanced firms. If, however, the same revenue threshold is applied to commercial insurance brokers it is likely many more intermediary firms will fall within the enhanced regime. Accordingly the figure of 75 seems rather low. Given the FCA has stated in the past that the RMAR is an important part of its supervisory approach to reduce the risk of poor consumer outcomes in the retail investment market, we understand the use of that as the test for retail brokers and believe that it makes sense. In terms of the commercial brokers, we would seek clarity over the test that should apply to them as we are concerned that applying the retail revenue threshold is inappropriate.

Other firms:

12.3 A number of our clients consider that the current thresholds will result in a significant number of firms (more than the FCA's estimate) being identified as enhanced with a wide range of firms being caught for different reasons.

12.4 A number of asset management firms were of the view that asset management firms should all be designated as core firms because the limited nature of the risks which they pose to market integrity is such that a more extensive regime is not appropriate. In particular, it was felt that very similar firms might fall in or out of the core regime depending on specific structuring arrangements rather than fundamentals of their business. With that in mind, a number of firms suggested that it would be appropriate that all asset management firms should be "core" for consistency of impact across the industry.

12.5 It is also suggested that on proportionality grounds exempt commodities firms should be excluded from the enhanced regime and should therefore, based on the nature of their business and their exempt status, be excluded from the core regime (even if they are caught as Significant IFPRU firms) – please also refer to our response to Question 21 below.

Group issues:

12.6 In the alternative, some of our clients expressed practical concerns with the division between core firms and enhanced firms in circumstances where within a group of companies some firms fall under the core regime and some under the enhanced regime. Our clients would welcome the optionality of applying a single regime to all firms within the group (where appropriate) with a streamlined process to opt-up to the enhanced regime.

12.7 Conversely, other clients were concerned that the criteria to identify enhanced firms would have adverse practical implications in that some firms would be able to opt in or opt out of the core and enhanced regimes by restructuring their group and allocating assets. In their view, the classification core/enhanced should be undertaken at a group level rather than on a company by company approach.

12.8 Also, some clients suggested that in order to avoid duplication of responsibility within a group of companies, some obligations should be set at a group level not at a company level. For example, there should be a single Responsibilities Map at a group level.

12.9 Where firms have in place exemptions to establish committees and functions at a group level, these should be maintained. We should be grateful for guidance to confirm that firms may rely on these group level governance structures for each regulated entity without further duplication. Avoiding duplicative statements of responsibilities and management responsibilities maps would be particularly helpful in this regard.

13. **Question 21 - Do you agree with our proposed approach to moving firms between core and enhanced? If not, please explain why.**

13.1 Under the current proposal a firm may briefly meet the criteria that results in them being categorised as an enhanced firm. As a result the enhanced rules will continue to apply for one year.

13.2 As an example, a commodities firm may briefly hold assets in excess of £530m and therefore be considered a significant IFRPU firm under the definition in the FCA Handbook (IFPRU 1.2 - Significant IFPRU firm). Once these assets have been unloaded, they will no longer meet this criterion but will continue to be subject to the enhanced rules for a further

12 months. This is the case no matter how briefly or infrequently the firm reaches the threshold. For some of our clients, this is a concern.

13.3 More generally, if the current thresholds are maintained, to avoid volatility it has been suggested that a firm should only become enhanced if a relevant threshold has been consistently met for at least one year. This will mitigate the risk of firms only meeting the criteria for a short period of time and then being subject to the rules for a full 12 months period.

14. **Question 22 – Do you agree with our proposed Senior Management Functions for enhanced firms?**

14.1 In the context of non-banking business, some of our clients would find it helpful if guidance could be provided what types of roles at a firm would be considered to fall under SMF18 (Other Overall Responsibility). In particular, it would be helpful to have more practical guidance (in the context of these firms' business models) in relation to the situations in which an SMF18 would be required (as opposed to the manager of a business unit being a certified person).

15. **Question 24 – Do you agree with our proposals for Prescribed Responsibilities in enhanced firms? If not, please explain why.**

15.1 Clients consider that PR13 (developing and maintaining the firm's business model) should not be allocated to a single individual and should be a responsibility of a firm's Board. In the alternative, they would prefer the language of the PRA's prescribed responsibility for banks which reflects the fact that the business model is a responsibility of the Board – "*responsibility for the development and maintenance of the firm's business model* ***by the governing body".***

16. **Question 28 - Do you agree with our proposals for Senior Managers in EEA Branches?**

16.1 We and our clients agree with the proposals for Senior Managers in EEA branches. We also agree that the principle of Home State prudential regulation should be preserved. However, with regard to the EEA Branch Senior Management Function, our clients seek more guidance/clarity on what constitutes such a function. The proposed rules in SUP 10C 8.4R refer only to persons with significant responsibility for one or more significant business units of the branch The SMF21 function of EEA Branch Senior Manager appears to be very similar to the Significant Management Function forming part of the FCA-specified Significant Harm Function under the Certification Regime (see SYSC 27.7.5R) and clients seek guidance on where the line falls / what amounts to a significant business unit for these purposes.

17. **Question 30: Do you agree with our proposals for Senior Managers in non-EEA branches?**

17.1 Clients have noted that (unlike EEA branches), non-EEA branches are not required to notify senior managers with responsibility for business areas within the branch but are required to appoint SMF3s (i.e. executive directors) and SMF27s (partners). It is questioned how this is intended to work for large global organisations where the board directors of the overseas entity (or partners of the non-UK LLP) have global responsibilities and responsibility for the relevant branch activity lies either with (i) senior individuals based in the UK who are not necessarily directors or partners or (ii) senior functional managers located outside the UK e.g. at the firm's head office. It is suggested that non-EEA branches should not be required to have SMF3s or SMF27s unless the executive directors or partners are in fact based in the UK and responsible for the UK business. Equally, they should have flexibility (but not be required to) appoint SMF18 individuals where it is not appropriate for the SMF19 to have all responsibility for the business of the branch and this is properly allocated to a number of individuals.

18. **Question 37 - Based on the summary above and the full analysis www.fca.org.uk/publication/research/cba-extensionsenior- managers-certification-regime.pdf, do you agree with our findings and conclusions for the cost-benefit analysis? If not, please explain why."**

18.1 The feedback we received from some of our clients is that the cost/benefit analysis in the Consultation Paper underestimates the costs that will effectively be incurred by firms, particularly given the complexity of group structures and the need to implement individual statements of responsibilities for all entities within group structures.

Simmons & Simmons LLP
03 November 2017

Appendix 1

OVERALL RESPONSIBILITY AND THE LEGAL FUNCTION

Discussion Paper DP 16/4 (the "Discussion Paper")

Simmons & Simmons LLP Response on behalf of Clients

1. Introduction

1.1 Simmons & Simmons LLP ("Simmons & Simmons") has spoken with a number of its FCA regulated clients across the breadth of the financial services industry. This includes a number of firms which are not yet subject to the Senior Managers and Certification Regime ("SM&CR") but are interested in the Discussion Paper in light of the extension of the SM&CR across the regulated industry in due course.

1.2 This response represents a range of views put forward by our clients. These clients have not been named for reasons of confidentiality; however, where possible we have identified the type of firm in order to assist the FCA. In general, our clients understand and acknowledge the need for rules that aim to enhance and embed a culture of individual responsibility and accountability within firms and the desire by the FCA to achieve complete coverage within a firm (i.e. a "no gaps" system).

1.3 However, our clients hold a variety of views and concerns about whether, and if so how, the SM&CR should apply to the legal department. Our clients also have concerns that while they may be able theoretically to accept some of the proposals, particularly where guidance and published reassurances can be provided by the FCA, there may nevertheless be some considerable practical challenges in applying the SM&CR to the head of the legal department and some unintended consequences in so doing.

1.4 At Annex 1 we have included two case scenarios which seek to demonstrate how some of these discussion points may operate in practice.

2. Scope of the Discussion Paper

2.1 The Discussion Paper poses two questions:

(A) "Do you agree with our summary in Chapter 3 of the key policy arguments for and against inclusion of the management of the legal function in the SMR? Have we missed any key arguments?"

(B) *"Do you believe that the SM&CR should include a requirement to allocate overall responsibility for the management of the legal function to a Senior Manager? Why?"*

2.2 In responding to the above questions, we have broadly structured this response to reflect the main issues raised in section 3 of the Discussion Paper, rather than focussing on the specifics of these two questions. As such this response includes:

(A) Executive Summary Section 3; page 2

(B) The Legal Department as a business activity Section 4; page 3

(C) Flexibility to allocate overall responsibility Section 5; page 5

3. Executive Summary

The head of the legal department should not be included within SM&CR

3.1 A number of our clients strongly consider that the legal department should not be, and was not intended to be, included within the SM&CR. In summary, they consider that:

(A) the statutory definition of a *"business area, activity or management function"* should not include the legal department; this was made clear in the Parliamentary debate preceding the statute's creation and subsequently in its definition;

(B) the role of the legal department is to provide legal advice; it is an evolution of bringing external legal advisors in-house to deliver a dedicated and specialised legal service; the FCA clearly cannot intend to regulate external legal advisors so it is unclear why they would seek to regulate the same role brought in-house;

(C) while there is recognition of the FCA's objective to create a 'no gaps' approach, certain clients consider that the purpose of the SM&CR is to deliver individual accountability of senior management who are performing high risk external or internal facing business functions; as such there is no 'gap to plug' by including the legal department within the SM&CR;

(D) it is not possible or practical to separate (as the FCA suggests it is) the advisory role of the legal department with the management of that role; the two are in reality entirely connected (see the case scenarios at Annex 1); and

(E) the proposed inclusion within the SM&CR would put the head of the legal department in unmanageable positions of conflict; he or she would not have control over demonstrating the reasonable steps he or she had taken (COCON 2.2, SC1) if he or she could not waive privilege over the advice given by the legal department; he or she would have competing obligations between his or her duty as a lawyer and his or her obligations under SC4 (COCON 2.2.4); the independence of his or her advice would be, or would be perceived to be, affected; he or she may face a variety of conflicts as a result of being dual regulated.

The head of the legal department should be included within SM&CR

3.2 However, certain of our clients do not, in principle, take issue with the inclusion of the head of the legal department within the SM&CR. This was particularly the case where the head of legal performs another Senior Manager role, where the legal department performs what they consider to be a 'control function' or works closely with other control functions (e.g. compliance), or frequently in smaller or less structurally complex firms. In summary, they consider that:

(A) while hopefully unlikely, it is possible that a failure in the management of the legal department could lead or contribute to significant failings by the firm; alongside the role of giving of legal advice, those clients consider that managing the legal department is part of the role as head of that legal department. In many cases, the General Counsel ("GC") will be the appropriate person to do this;

(B) the heads of those legal departments recognise that there is, at least hypothetically, a distinction between 'management' (and the need to ensure there are no gaps in management) and the giving of legal advice; nonetheless they would welcome clearer guidance on the practical challenges as to how the FCA intends to distinguish between the two;

(C) while there remain concerns about the protection of privileged communications, the independence (and perceived independence) of the legal department, handling conflicts where they arise, these clients considered it may be possible to manage these issues with appropriate guidance and published clarification from the FCA.

3.3 It was notable that from the broad and extensive community of clients who contributed to this response, almost all remained concerned that issues surrounding legal professional privilege ("LPP"), its protection and the ability of the head of legal (or indeed other Senior Managers) to defend themselves in an investigation/enforcement action where they were not the owner of that LPP, has not been adequately addressed by the FCA.

3.4 Our clients welcome the FCA's willingness to discuss these issues and strongly express an expectation that these issues will be subject to a formal consultation process and, should any changes be implemented, that detailed guidance will be issued.

4. The legal department as an "activity, business area or management function"

4.1 A number of our clients considered that the legal department does not fall within the plain English reading of section 59ZA of the Financial Services and Markets Act 2000 ("FSMA"). Put simply, the legal department does not perform an '*activity, business area or management function*' as envisaged by the SM&CR when its role is to provide legal advice. Those clients consider that this position is supported by the Parliamentary debate which clarified that the provision did not intend to include lawyers or the provision of legal advice:

(A) Lord Flight stated: ***"****The objective is to ensure that the provision of legal advice is not to be construed as taking decisions or participating in the taking of decisions, and for situations where solicitors and other legally qualified professionals frequently give advice on decisions which a bank or other institution may take. They do not make the decisions, but purely advise on legal issues…"*; and

(B) Lord Newby, answering on behalf of HM Treasury stated: *"it is therefore highly unlikely that the regulators would designate being a legal adviser as an Senior Management Function because giving advice does not constitute management asset out in the definition of senior management"*.

4.2 The FCA have stated that it is the '*management of the function and not the provision of legal advice'* that they intend to regulate within the SM&CR[1]. If it is correct, which certain clients do not accept, that the intention of Parliament was to include the management of all areas within a regulated firm, the plain reality is that separation of management of the legal department from the role it performs will be unworkable in practice (see section 6 below and the case scenarios at Annex 1).

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1 See DP16/4, paragraph 3.21

4.3 By contrast, some of our clients consider that the wording is sufficiently broadly drafted, whether intentionally or otherwise, to include the legal department at least in respect of its management, within the meaning of section 59ZA of FSMA. In some firms the legal department delivers a critical control and risk management function which is analogous to Compliance, Risk and Internal Audit and the performance of this role is a key component of good corporate governance.

What function does the legal department perform?

4.4 Our clients considered that the scope and purpose of the legal department significantly varied from firm to firm and was heavily influenced by a firm's particular business activities, internal structures and decision making processes. For example, in some firms the head of legal attended board and internal governance committees solely as an advisor and was not a decision maker; however, in other firms the head of the legal department had a dual role as a decision maker and a legal adviser in decision making processes.

4.5 A number of our clients (particularly amongst asset managers and smaller banks) remained of the view that the legal department was purely advisory and as such is not a decision maker. Their internal corporate governance and decision making structures have been designed on that basis. Whilst the head of the legal department is still a critical stakeholder and plays a fundamental role in corporate governance, he or she is not a decision maker.

4.6 These clients expressed the view that it was not a regulatory requirement to have a legal department (in the same way as it is for other control functions) and therefore the FCA was at risk of 'over-reaching' by fundamentally changing the scope of its remit without full consultation. Some clients considered that, in circumstances where the FCA would not seek to extend the SM&CR to external legal advisors, it does not seem appropriate to take a different approach with in-house lawyers. Further, it seems incongruous that regulated firms with dedicated and experienced in-house legal teams, with the benefits of accessibility and expertise that that brings, will be more scrutinised by the FCA than those firms which only rely on external legal advice.

4.7 However, this was not a consensus view; a number of our clients, particularly those with an international presence, considered that the scope and purpose of the legal department has evolved in their particular organisation from being a purely advisory function to being a control function or a 'line of defence' which is accountable for managing legal risk. These clients consider that, as well as the advice that is given, the framework in which it is given to ensure that it is appropriate, timely, delivered at the right level by the appropriately experienced person(s), the application of quality assurance etc., is part of the role of the head of the legal department. For some of these clients, the role of the legal department goes further and is fundamentally integrated with the business and the other control functions. Lawyers in these teams are not only giving legal advice but using legal expertise and skills in contributing to the performance of the business, i.e. they are doing a business role with their knowledge of the law. For some organisations, the legal advice is part of the business decision-making at board level and a number of GCs we consulted considered that it would be disenfranchising for them to be excluded from the SM&CR.

Guidance sought from the FCA

4.8 Clearly, there is variation within organisations as to the role of the legal department and thereby also the remit of the head of that function. The fact that there is such variance in the role of the legal department means that the FCA needs to be clear precisely what it is seeking to regulate by including the legal department within the SM&CR. Further, our clients were concerned to make sure that the FCA's 'one size fits all' approach would not restrict a firm's ability to decide, on the basis of its own structure and governance, what role the head of the legal department should play in its business (for example its role in decision making).

4.9 If the FCA considers that the legal department falls within the statutory wording of section 59ZA of FSMA, plainly not everything performed by the legal department falls within this wording. Accordingly, clear guidance should be given by the FCA as to what activity or management aspects of the legal department it intends to regulate.

4.10 For example, the FCA should consider providing:

(A) a non-exhaustive list of items which would fall within the management of a function, for example: resourcing, training, recruitment and systems and controls (see paragraph 5.3 below); and

(B) clear guidance as to what does not amount to 'management' (e.g. guidance that the FCA does not intend to regulate the provision, or quality, of legal advice itself); and

(C) a view on how the SM&CR would be enforced for the 'management' aspect of the role but not the advisory aspect if they were carried out by the same person.

5. <u>Flexibility to allocate overall responsibility</u>

5.1 The FCA has indicated that an organisation's flexibility to allocate overall responsibility of the legal department is a solution that both resolves some of the issues that arise with the GC being the head of the legal department and gives a degree of freedom to many regulated firms which are inevitably going to be structured in different ways. In reality, that supposed flexibility may not go far enough, it may not be possible or appropriate to take advantage of it and it may not solve some of the problems that arise.

5.2 The following issues were raised by our clients and provide practical detail for the FCA's consideration about how legal departments are currently structured.

<u>Structure</u>

5.3 A number of our clients have in place a "Chief of Staff" or "Chief Operating Officer" model which is designed to enable the head of legal to delegate administrative tasks and the day to day management and of the legal department. These clients consider that many of the responsibilities delegated through this model would likely fall within the scope of "operational management of the function" (paragraph 3.24 DP16/4), for example systems and controls around budget, training, recruitment, procurement of legal services, resourcing and performance management and compensation. This role does not extend to the giving and receiving of legal advice, although in some cases this role is performed by someone with a legal background and/or a qualified lawyer. However, in most cases this person will report to the head of the legal department who might be more naturally described as the person with "overall responsibility for the legal function".

<u>General Counsel</u>

5.4 A number of clients expressed the view that it would not be realistic to expect anyone else other than the GC to be the head of the legal department. Indeed, to remove that role from the GC would not only be impractical and risk introducing a less appropriate or less qualified individual into the role, but it may also have the effect of 'disenfranchising' the GC. The GC is, in most regulated firms, often the most senior person with knowledge of and comprehensive oversight of the legal department. A number of our clients indicated that they would be unable to justify to other Senior Managers why the GC should fall outside the SM&CR.

5.5 In practice, the day to day oversight and direction of the legal advice provided by the legal department, as the primary product delivered by the legal team, will still fall to the GC as the most senior lawyer in the business, as will the handling of the most challenging legal risks (and in some firms the decision making). Therefore, any enquiries or concerns about the performance of the legal department will ultimately fall to the GC, even if the overall responsibility for the department is nominally allocated elsewhere.

Dual roles

5.6 A number of our clients, especially firms with smaller or combined legal departments, raised the point that the head of the legal department may already be a Senior Manager (or an approved person for firms not yet within the SM&CR) by virtue of other roles he or she performs. For example in some organisations the head of legal may also be responsible for compliance or hold a directorship with the firm. If his or her role as the head of the legal department also falls within the SM&CR there will be less practical change to his or her existing individual accountability. For those clients in that position, the flexibility to allocate responsibility is helpful; but it does not solve all their concerns.

5.7 For those in senior management with dual roles, the challenge in identifying where one role stops and another begins already exists. However, the importance of identifying where management of the legal department ends and giving legal advice begins would also come under close scrutiny. The reality is that individuals performing a dual Senior Manager role, including the head of legal, will experience the same challenges faced by those solely in that role but, by virtue of already being within the SM&CR, a number of those individuals are already more willing to accept the 'no gaps' argument put forward by the FCA.

Global, corporate or matrix management structures

5.8 A number of our clients, especially firms that are more global in nature or are located primarily in other jurisdictions outside the UK, expressed concern about how the FCA would approach the role and performance of the head of the legal department in circumstances where the ultimate decision making about the management of the legal department was primarily conducted in another jurisdiction (for example budgetary decisions which impact resourcing in the UK). This is not unique to the legal department and may be true of other business divisions; however the legal department will typically have a wide interface with the whole of a business. Key management decisions such as resourcing, training, etc. are therefore more likely to be centrally managed (whether outside the UK or elsewhere in the business).

5.9 In these circumstances our clients were concerned that they would be unable to demonstrate that they had taken reasonable steps in respect of managing the legal department where they are not the ultimate decision maker on key issues which would impact effective management for the UK perimeter. The situation would be further complicated where the head of the legal department is located outside of the UK (and therefore potentially is not a UK qualified lawyer).

5.10 This concern was also shared by a number of clients, especially firms which conduct regulated business as an ancillary service to their main commercial activities or firms which conduct a mixture of regulated and unregulated business, in circumstances where the broader corporate agenda, decision making and direction are influenced by factors outside of the FCA's jurisdiction and outside of the head of the legal department's control and influence.

Guidance sought from the FCA

5.11 It may assist if the FCA were to provide guidance as to what it considers will amount to reasonable steps taken by the head of the legal department in demonstrating that the legal department is controlled effectively. This is closely tied with the FCA providing guidance as to what it considers amounts to management of the legal department. In particular, it would assist to understand whether those steps will differ if a firm chooses to allocate this role to someone who is the GC, or someone who is another Senior Manager and whether any specific allowances should be made for someone who is also performing a legal role.

5.12 Separately, if the primary concern of the FCA is that there should be 'no gaps' in the SM&CR so that it is able to identify who takes responsibility for the legal department but it recognises the challenges including the head of the legal department in the SM&CR, could the objective be met with the inclusion of a responsibility map for the head of the legal department without that role being a Senior Manager position?

6. Legal Professional Privilege

6.1 The need to protect LPP, i.e. a client's fundamental right to access legal advice in the knowledge that the discussions and advice will be protected from disclosure and not used against it, is at the heart of what makes the advice from a lawyer different from the advice from another business person. It was a consistent concern, across the population of firms consulted, that the FCA has not fully anticipated the consequences of extending the SM&CR that either places the head of the legal department in a fundamentally conflicted position or will result in the further erosion of the principle of LPP, which is in direct conflict to the stated intention of both Parliament and the FCA – equally unacceptable outcomes.

LPP and regulatory conflict

6.2 LPP is a protection afforded to the client, not the lawyer. Our clients were keen to ensure that the FCA understands that these concerns do not result from "legal exceptionalism" but rather the need to explain the fundamental characteristics of the role that lawyers perform for the benefit of their clients – who alone enjoy the privilege.

6.3 If the head of the legal department falls within the scope of the SM&CR, that individual will be required to demonstrate that he or she has taken reasonable steps to ensure that the business of the firm for which he or she is responsible is controlled effectively (COCON 2.2, SC1). Similarly, the head of the legal department must disclose appropriately any information of which the FCA or PRA would reasonably expect notice (COCON 2.2.4, SC4).

6.4 In circumstances where the head of the legal department is being investigated in his or her role as Senior Manager, it is very possible that the legal advice that was given will be the only evidence demonstrating that those reasonable steps have been taken by the individual in that role. The head of the legal department is unlikely to be able in all cases to waive the privilege over that legal advice in order to demonstrate that he or she has discharged his or her duty of responsibility as the privilege can only be waived by the client. This puts the head of the legal department in a fundamentally conflicted position.

6.5 That conflict might be surmountable if the firm were prepared to waive that privilege but the head of legal does not enjoy control over that, and the situation would be fundamentally exacerbated if the actions of the firm and the advice given by the legal department were at odds. It would be even further exacerbated where the head of the legal department is no longer with the firm.

6.6 A further conflict might arise (or be perceived to arise) which impacts the head of the legal department's ability to manage and advise the firm in respect of an FCA or PRA investigation, in circumstances where their own conduct or competence is also in question. In these circumstances the firm might be in a problematic position where the head of the legal department is unable to perform a key part of his or her role.

6.7 Another conflict may arise, if the GC has become aware of information during the course of legal advice being provided by the legal department that might otherwise amount to information covered by SC4. The FCA has indicated (though formal confirmation may assist) that it does not consider that privileged communications will be information about which the FCA could reasonably expect notice. It has not clearly indicated whether it would expect notice of factual information, which underpins the legal advice sought or any resulting action (or inaction), to be notified to the FCA even if the privileged communications are protected.

6.8 It has been raised by the FCA, and indeed some clients, that other Senior Managers are in a similar situation; i.e. the Head of Compliance may need to demonstrate his or her reasonable steps and that obtaining legal advice may be part of that demonstration. However, it was widely considered that a Compliance Head (etc.) will be able to show multiple steps that were taken, including the reasonable step of seeking legal advice to discharge that duty. The giving of legal advice is at the core of what the legal department does. Some clients considered that, for most issues which would come under scrutiny, the only reasonable step that the head of legal would be able to rely on is the fact that he or she was asked for and gave (or delegated appropriately to another lawyer to give) legal advice but without being able to disclose it.

<u>Separation between management and legal advice</u>

6.9 As has been noted above (at paragraph 4.2), the FCA has stated that it does not seek to regulate the giving of legal advice and that it is only interested in the management of the function. The FCA has not presently clearly indicated what it regards amounts to 'management' and what does not (hence why we consider guidance on this will assist). Our clients were emphatic, however, that while this distinction may be possible intellectually, in reality one of the main ways in which a failing in the management of the legal department will often manifest itself is in poor quality legal advice being given. Put simply, limited resources, inappropriately qualified or experienced lawyers, poor reporting lines, inadequate training (to name a few possible 'management' issues) within the legal department will only be capable of testing by the FCA in a meaningful way by asking for the legal advice that was given. Some practical examples of the overlap between management and legal advice are set out in Annex 1.

<u>The FCA's approach to LPP</u>

6.10 The FCA has sought to rely on the statutory protection that exists at section 413 of FSMA preventing the disclosure, production or inspection of Protected Items (i.e. privileged communications) to assert that there is no obligation on the part of a firm to disclose privileged communications. The FCA has also indicated that it would typically be extremely difficult to bring a successful action for a breach of the duty of responsibility solely in reliance on privileged communications (presumably provided to the FCA under a limited waiver) if the firm has not chosen fully to waive privilege over it[2].

6.11 Many of our clients consider that this does not go far enough. For example, the FCA has not indicated what position it would take where non-privileged communications are sufficient evidence to bring an action for a breach of the duty of responsibility but where

2 See DP 16/4, paragraph 3.27.

privileged material is sufficient to defend it. The FCA has not indicated what it would do in circumstances where it had either seen the privileged communications (on a limited waiver of privilege basis) or where it had not been disclosed save that the FCA understood from the relevant Senior Manager that it existed and was exonerating. Further the FCA has not indicated how it would approach the drafting of statutory notices which place evidential reliance on privileged communications for which it has only been granted a limited waiver,as public disclosure would result in the LPP being lost. Whilst some of these challenges already exist, the extension of the SM&CR to the head of the legal department means that it is likely to arise much more frequently and to be of more importance to the matters in dispute.

6.12 Additionally, the FCA has so far declined to confirm that it will adopt the position taken by the English courts that no adverse inferences will be drawn from a failure by a Senior Manager to provide LPP communications, including (and perhaps more so) in circumstances where that privilege was not his or hers to waive. Our clients consider clarification on this point is essential before they can accept that the head of legal should be within the regime, particularly because it goes to the heart of what the head of legal does i.e. oversight of a team that provides legal advice.

6.13 Our clients already have growing concerns about the general erosion of LPP, in part because of the perceived or actual pressure placed on firms to waive privilege over materials during enforcement investigations, recent public statements from senior members of the FCA itself requesting that firms conduct internal investigations so as to avoid privilege applying, and the absence of confirmation that not waiving privilege will not lead to adverse inferences being drawn by the FCA.

6.14 The pressure and concerns around disclosure of LPP communications already exists; but the issue is exemplified when considered in the context of a Senior Manager placed in an impossible conflict and particularly the head of the legal department who will have significant regulatory responsibilities that he or she may not be able to demonstrate have been met. Additionally, the risk that LPP communications will be disclosed will have a significant impact on the independence of the legal department, the quality of the legal advice and the culture of the firm.

Guidance sought from the FCA

6.15 Our clients request that, should the head of the legal department ultimately be included in the SM&CR, the FCA will:

(A) provide additional guidance in respect of its approach to enforcement against the head of the legal department, including that no adverse inference shall be drawn from non-disclosure of Protected Items and/or LPP communications (and the ability of a firm, head of the legal department or other Senior Manager to rely on the fact of legal advice in circumstances where a Protected Item is not disclosed);

(B) provide additional guidance as to the FCA's expectations of the head of the legal department where he or she becomes aware of information during the course of legal advice being provided by the legal department, that may amount to information envisaged by SC4. The FCA has indicated that it does not consider that LPP communications will be information about which the FCA could reasonably expect notice, however clarification around these issues would be welcome; and

(C) take this opportunity to reconsider its overall approach to LPP in both its supervisory and enforcement capacities, including whether secondary legislation may assist in addressing the disclosure of LPP communications to the FCA/PRA i.e. provide further protection for those disclosing/requiring disclosure of LPP communications.

7. **Independence of the legal department**

7.1 A number of our clients expressed significant concern about the negative impact the introduction of the SM&CR could have on the actual or perceived independence of the legal function. In circumstances where the head of the legal department has an obligation to disclose to the FCA/PRA information of which they might reasonably expect notice (SC4) and has increased personal accountability to the regulator and may be perceived to be or actually required to disclose LPP communications in defence of his or her position, there is a risk that the quality of the legal advice may be (or may be perceived to be) less frank, more risk averse, and cease to have as much value to the business.

7.2 Of interest, a number of our clients expressed concern that a firm's ability to improve and develop a compliant culture will be significantly impacted by the inclusion of the legal function within the SM&CR. The clear regulatory message that risk issues should be identified, escalated and mitigated will be undermined if firms, individuals and other Senior Managers are wary about the ability of the firm to protect its right to seek legal advice on the basis of full and frank disclosure. Our clients place a high value on their ability to seek legal advice within the protection of privilege.

7.3 A number of our clients considered this might discourage the business from using their inhouse lawyers, or to use them in limited or qualified ways, to seek advice from external counsel, or to request that the advice be delivered orally. As raised above, LPP protects the client not the lawyer. This in turn would, in fact, weaken the overall ability of a firm (and its other Senior Managers) to evidence (through the disclosure of contemporaneous legal advice should privilege be waived) that reasonable steps were taken. A few clients took a slightly different view, that increased accountability may not, in fact, impact the way in which advice was given (i.e. the risk of personal liability would not influence the legal advice) but that their client's perception was the key issue. Our clients are concerned by the perception that the head of the legal function will have a personal conflict of interest when advising the business, other Senior Managers or the board on the most challenging legal issues.

7.4 A number of our clients indicated that the exclusion of the head of the legal department from the SM&CR would have a negative impact on the ability of that individual to perform a meaningful and influential role. It would impact the ability of regulated firms to recruit and retain specialist lawyers and down grade the role in-house lawyers play in good corporate governance.

8. **Multiple Regulation**

8.1 Our clients identified a risk that through multiple layers of regulation by the FCA, the SRA, the Bar Association or the professional rules of foreign registered lawyers there was a risk of competing, sometimes conflicting, regulatory requirements placed on in-house counsel. In particular, it was felt that the FCA needed to give further consideration to the obligations under COCON 2.2.4 SC4 and the increased level of personal accountability to the regulator with the duties of client confidentiality (SRA Code of Conduct, Chapter 4), the duty to act in the best interests of the client (SRA Principle 4) and the duty of independence (SRA Principle 3).

8.2 However, while our clients are concerned about the imposition of additional regulatory obligations on in-house lawyers through the extension of the SM&CR they recognise that other in-house professionals are also dual regulated e.g. accountants, actuaries or company directors (although the severity of sanctions for misconduct may vary).

Guidance sought from the FCA

8.3 Our clients consider that it would be highly desirable for the FCA to explain how it would expect a Senior Manager to act in circumstances where there was a conflict between different professional regulations or where there were different standards between those regulations.

9. Conclusion

9.1 A spectrum of views have been expressed by our clients in response to the central question of whether the FCA should include a requirement that firms allocate overall responsibility for the management of the legal department to a Senior Manager. However, our clients universally expressed concern that an extension of the SM&CR to the head of the legal department represents a fundamental step change in regulation (as a corresponding head of legal role was not within the approved person regime) which should be subject to a full consultation process.

9.2 Many of our clients considered that the primary policy objective of the FCA, to ensure that individuals at regulated firms adhere to the highest standards of conduct and are accountable to the regulator when things go wrong, is already delivered through the Individual Conduct Rules. The broad applicability of the Individual Conduct Rules provides the FCA with the ability to hold in-house lawyers (including the head of the legal department) to account against the core principles of integrity, due skill, care and diligence and against the COCON 2.1.3 Rule 3 requirement to be open and cooperative with the FCA, PRA and other regulators.

ANNEX 1 – CASE SCENARIOS

Scenario 1 – Duty to notify the regulator

A trading desk head becomes concerned that a particular trading practice may amount to market manipulation. The coverage lawyer allocated to the desk is consulted and she gives legal advice, based on her understanding of that particular issue, that it is potentially an abusive market practice. She escalates the issue to her immediate superior within the legal department who is on annual leave. The coverage lawyer is unaware that a similar potentially abusive practice is also taking place elsewhere in the firm. Her advice is eventually escalated, but only after some weeks, to the GC.

The GC considers that the practice might be abusive and advises the Head of Compliance (who is responsible for regulatory notifications) that a Principle 11 notification should be made to the FCA. The GC is unaware that the same practice is taking place elsewhere within the firm but advises that there is a risk that such behaviour is capable of being replicated on other desks. The Head of Compliance does not accept the advice as he considers it is made on the basis of an isolated incident and the risk has been mitigated by additional trade monitoring on the desk. No notification is made.

The abusive trading practice in multiple parts of the firm is identified by the FCA at a later date and the firm is referred to Enforcement for, among other matters, a potential breach of Principle 11. As part of the potential Principle 11 breach, the FCA is considering:

- the role of Legal in identifying and escalating the issues;
- the delay in escalating certain instances of potential market manipulation and the failure to identify other instances, or risks of other instances, at all;
- failures in resourcing staff during annual leave; and
- whether the GC had taken reasonable steps in managing the legal department.

The firm provided evidence to demonstrate how Legal was resourced, structured and organised: the qualification and expertise of the coverage lawyer, reporting lines and compliance with the escalation procedures. The firm confirms that legal advice was given to the Head of Compliance by the GC but chooses not to disclose the legal advice to the FCA.

Six months later the FCA extends its investigation to the Head of Compliance (as the person responsible for regulatory notifications) and the GC (as the person responsible for the management of the legal department) as part of its objective to ensure individual accountability.

The firm chooses not to disclose the legal advice but both the firm and the Head of Compliance seek to argue that the fact that legal advice was sought is evidence of reasonable steps taken in considering whether to make a notification. The GC wishes to disclose the legal advice as it evidences that, notwithstanding some of the resourcing and escalation issues within the team, the advice given was still timely and appropriate. The GC cannot, of course, waive privilege over the legal advice itself.

In these circumstances:

- How can the GC demonstrate he took reasonable steps to the FCA?

- Would the FCA be able to hold the GC accountable for a "failure" of the legal function, without undertaking an assessment of whether the advice itself was reasonable?
- What if the Head of Compliance and/or GC is no longer at the firm?
- What if the advice of the GC was limited to the practice and did not consider the monitoring system?
- Does SC4[3] mean that the GC should have made a notification to the FCA himself?
- What if the advice of the GC was wrong and the issue did not require a notification?

Scenario 2 - Management of the legal function and acting with due skill, care and diligence

A firm is considering launching a new retail product and has submitted the draft marketing materials, structural documents and terms and conditions to Legal for review and approval. The business is under pressure to launch the product by the end of the week in order to meet its yearly target. The request is allocated to a junior lawyer who supports the desk. His line manager recently moved to New York and he does not have an immediate reporting line in London. He is aware, however, that the firm previously received external advice in respect of a similar product. He emails his line manager in New York to seek approval and budget for updated external advice. He is aware that there was recent training on this topic by the same external law firm but he did not attend it and the knowhow system with the slides has not been updated.

No response is forthcoming from his line manager in New York so he relies on the previous advice and approves the documentation. The product is submitted for approval to the New Product Committee which is chaired by the Head of Compliance. It is subsequently launched and sold to over 10,000 investors.

Six months later the asset underlying the product is found to be worthless due to a corporate collapse. The marketing materials and terms and conditions provided to investors were not sufficiently detailed or transparent about the risks and may not have met current regulatory requirements. The FCA is concerned about consumer detriment and requires the firm to undertake a section 166 review in respect of the product, the firm's product governance process, the communications with investors etc. and consider redress where appropriate.

The skilled person reviews the documentation submitted to the New Product Committee (but the legal advice given by the junior lawyer is redacted on the basis of legal advice privilege). The firm's litigation team review the papers submitted by the firm to the skilled person and are concerned by the content of the legal advice given and the over-reliance on previous external advice which pre-dated the change in the regulatory rules.

In these circumstances:

- How can the Head of Compliance demonstrate that it was reasonable to rely on the documentation submitted to the New Product Committee (which included the legal advice)?
- How can the head of the legal department demonstrate that the resourcing and allocation of work within the legal function was reasonable, notwithstanding that there was an error in the advice? Does the fact that the supervising lawyer is a lawyer from another

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3 *You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice*

jurisdiction impact any assessment about whether the reporting and supervisory lines were reasonable?

- Would the FCA seek to bring enforcement action against the junior lawyer, line manager or the head of the legal department under the Individual Conduct rules (Rule 2) for failing to act with due skill, care and diligence?

- How can the skilled person complete its review without access to the legal advice?

Appendix 2

FCA ASSET MANAGEMENT MARKET STUDY

Final Report MS15/2.3 (the "Final Report") and Consultation Paper CP17/18 (the "Consultation Paper")

Simmons & Simmons LLP - Response on behalf of clients

1. **Introduction**

1.1 Simmons & Simmons LLP ("**Simmons & Simmons**") has spoken with multiple of its FCA regulated asset management clients and contacts across the financial services industry about the Final Report. This response takes into account a range of views put forward, including thoughts on the accompanying the Consultation Paper. This response is made on behalf of our clients in general and is not attributable to or to be taken as the position of any individual client of Simmons & Simmons.

2. **Our response to the Consultation Paper**

2.1 The Consultation Paper seeks views on a number of proposed remedies including:

(A) a new Value for Money rule, which would require authorised fund managers to assess Value for Money on an ongoing basis and which would need to be documented formally on an annual basis;

(B) new governance requirements providing that authorised fund managers must appoint at least two independent directors to their board and a 25% proportion;

(C) a requirement that fund managers return any risk-free box profits to the fund and disclosure of approach; and

(D) a modification to existing FCA rules to facilitate switching investors to cheaper share classes.

2.2 Further, the FCA proposes introducing a new Prescribed Responsibility under the extension of the Senior Managers and Certification Regime ("**SM&CR**") which is subject to a separate consultation process (CP17/25).

2.3 We have chosen to focus on particular key themes in our response to the Consultation Paper: the concept and scope of the Value for Money rule; the proposed rule changes on governance; and the suggested extension of the SM&CR.

3. **Executive Summary**

Value for Money

3.1 Whilst our clients understand and support the FCA's customer protection agenda, they have expressed concern that the introduction of the duty to assess whether Value for Money has been delivered (on the current specific and granular basis), is less than straightforward in circumstances where this remedy is intended to strengthen an underlying duty which the FCA recognise is only implicit. Our clients ask that the FCA provides a non-exhaustive list of considerations, as guidance, to enable firms to assess the framework through which Value for Money is to be delivered (not whether it has been delivered as a matter of fact). Our clients feel that this would better reflect the FCA's intentions and would enable firms to consider a more holistic set of factors which all form part of good practice in terms of assessing client outcomes.

3.2 The proposed requirement to publish a Value for Money report should be focused on how the authorised fund manager has assessed Value for Money for investors as a whole, not whether Value for Money has been in fact delivered. This is in line with the Financial Reporting Council's proposals for non-financial reporting by directors about how they have fulfilled their duties as directors.

3.3 Our clients consider that assessing Value for Money by reference to "good" or "poor" creates a disproportionate expectation that Value for Money is measurable in absolute terms. It will lead to assessments with the benefit of hindsight, which will fuel unreasonable expectations amongst investors and will create significant legal and regulatory risk for fund managers when reporting to investors.

3.4 Our clients are strongly of the view that the new requirements to assess Value for Money should be delayed until after MIFID II, PRIIPS and the extension of the SM&CR are implemented and embedded. This is important to provide greater certainty for business planning purposes, in uncertain times further regulatory uncertainty about the timing and implementation of key regulatory changes can become a source of competitive disadvantage for the UK.

Governance

3.5 Our clients consider that having independent directors on the board of an authorised fund manager would support high standards of corporate governance through independent oversight for the benefit of investors. Our clients are supportive of the opportunity and flexibility to appoint a diverse range of independent directors without them necessarily having to have a financial services background, however practically the proposed appears to be potentially inconsistent with the expertise and experience required to assess Value for Money.

3.6 Our clients do not agree with the prescribed 25% proportion of independent directors, which appears arbitrary. Our clients are of the view that it is sufficient that the rules require at least one independent director with flexibility for more if deemed appropriate. Our clients consider that it would be most appropriate to allow firms to decide whether an independent director or an executive director should be chair (and therefore hold the new Prescribed Responsibility), although they question whether a non-executive director would be willing to accept this level of responsibility or discharge the function without a very detailed knowledge of the business.

3.7 Our clients do not want there to be a "race" to hire the "best" independent directors which could increase costs. It is well recognised that independent directors must be free of unmanageable conflicts between competing fund managers, an assessment of which will be undertaken on a case by case basis. Such appointments will require careful scrutiny and guidance for independent directors on induction about compliance with company, competition and regulatory law in fulfilling their duties as an independent director (and, if applicable, as a Senior Manager). We consider that these conflict issues need to be considered more broadly by the FCA and, on the current proposals couldresult in more than 480 additional independent directors being required. Our clients do not consider 12 months to be sufficient time for the implementation of independent directors.

The wider context

3.8 Our clients would like the FCA to recognise more clearly the context in which the current proposals sit. The industry is facing a period of fundamental and unprecedented regulatory change (particularly with MiFID II, PRIIPS and the SM&CR) against the backdrop of an uncertain future post-Brexit. Our clients would therefore like to see the FCA carefully assess the timing, scope and impact of these proposed new rules.

3.9 Our clients note that whilst the Asset Management Market Study was originally focussed on competition concerns, several of the FCA's final proposals appear to have broadened significantly in scope and impact. Our clients remain concerned that the ability of the FCA to deliver meaningful remedies to address competition (or wider regulatory) concerns in the interest of consumers is impacted by the current gap in assessing and promoting holistic regulatory change across the wider distribution chain (for example, the Investment Platform Market Study which is still at a preliminary stage).

4. **Value for Money**

Do you agree that we should introduce a specific rule requiring AFM boards to assess value for money?

Do you agree with the specific requirements of the assessment? If not, what additional or alternative elements should be included?

The "Value for Money" concept

4.1 Our clients consider that the concept of Value for Money is broadly aligned with the consumer protection agenda and recognise that it builds on the existing principle of Treating Customers Fairly and requirements to act in the best interests of investors. However, our clients are concerned by the FCA's desire to introduce a granular Value for Money assessment regime on this one aspect of the product lifecycle, delivered by just one part of the distribution chain. The "best interests" requirements in existing regulations were not directed at addressing the absence of effective competition now identified by the FCA, such that there appears to be a mismatch between the very granular and price focused assessment duty, and any underlying duty itself.

4.2 We note that the FCA is not seeking to introduce a specific duty to deliver Value for Money and that the FCA's determination that a specific duty is not required does not form an express part of the current consultation process. That is because the FCA is seeking to rely on broader and pre-existing regulatory obligations without change and, also, presumably, because it considers it does not need to consult on the ambit of existing obligations. The existing obligations in question are summarised below:-

(A) *"a firm must act honestly, fairly and professionally in accordance with the best interests of its client"* (COBS 2.1.1);

(B) the duty to *"ensure that fair, correct and transparent pricing models and valuation systems are used…in order to comply with the duty to act in the best interests of the Unitholders"* (COLL 6.6A.2(4)(a));

(C) the duty to *"prevent undue costs being charged to any scheme it manages and its Unitholders"* (COLL 6.6A(5));

(D) an authorised fund manager must, in carrying out its functions, act *"solely in the interests of the UCITS scheme and its Unitholders"* (COLL 6.6A.2(6)); and

(E) *"a firm must pay due regard to the interests of its customers and treat them fairly"* (Principle 6).

4.3 The "strengthening" of the duty to act in the best interests of investors is intended to be achieved not by changes to the above existing underlying duties, but by clarification and governance changes. The FCA has been fair in recognising that the existing regulatory regime does not include an explicit and well defined obligation to seek Value for Money for investors and no change in that respect is proposed. The final remedy proposed will therefore consist of:

(A) a broadly expressed duty to act in the best interests of investors with no mention of Value for Money and no granularity as to the extent to which "best interests" encompasses Value for Money; and

(B) a granular and highly specific assessment obligation directed at an unstated and unmentioned aspect of the broadly stated best interests obligation *i.e.*, Value for Money.

4.4 The Consultation Paper does not seek views as to whether the ambit of the Value for Money assessment obligation is consistent with the underlying duty or whether firms are at risk of being required to assess whether they have provided something which, in fact, they do not have an underlying obligation to provide (at least not to the same regulatory standard as the assessment obligation). In our view aspects of the assessment obligation are wider than the underlying obligation.

4.5 Our clients accept some aspects of the concept of Value for Money as articulated in COLL 6.6.21 (as proposed) fall within the existing COLL 6.6A (e.g. the duty to prevent "undue costs" in COLL 6.6A(5)). So unreasonably high charges cannot be charged and an authorised fund manager cannot ignore the interests of unitholders in agreeing costs which will be charged to a scheme; it has a duty to get a good deal. There is no quarrel that those aspects of Value for Money as now proposed are firmly within the existing rules and regime, and rightly so.

4.6 Where matters become more difficult is where the loosely framed "best interests" is translated, with granularity, to the presumption of an existing regulatory obligation to consider issues such as passing on savings and benefits from economies of scale to unitholders, or to consider break points.

4.7 COBS 2.1.1 is targeted at the best interests of a firm's client, and COBS 2.1.1(3) makes clear that "client" in that context means the UCITS scheme, not the unitholders. So the existing rule has a different scope to COLL 6.6A.2(6) which our clients accept is very clearly targeted at both the UCITS scheme and unitholders.

4.8 The wording and purpose of the UCITS Directive underlying COLL 6.6A strongly suggests that the directive was not directed at the "function" of setting pricing policy in that sense. Had it been, COLL 6.6A would not direct price to be set "solely in the interests of the UCITS scheme and its unitholders" (COLL 6.6A.2(6)), as any commercial purpose would then have been defeated. That cannot have been the intention.

4.9 COBS, COLL and the UCITS Directive were not introduced with a competition agenda in mind or within scope. Indeed they predate the FCA's responsibility for competition matters. It is also worth noting that in so far as the UCITS Directive is concerned (being a directive intended to harmonise regulation across the EU), other financial regulators within the EU do not have the same competition agenda as the FCA now has. Our clients see significant scope for uncertainty if regulations implemented and drafted prior to the FCA's competition powers are going to be re-interpreted to imbue them with significance to the regulation of competition.

4.10 While our clients understand the FCA's customer protection agenda, it appears questionable that the existing rules give rise to an underlying duty to provide Value for Money of the nature and granularity now proposed in the assessment obligation. If that is right, there is then a mismatch between stipulating detailed rules for an assessment in circumstances where the underlying duty is less extensive than the proposed duty to assess.

The duty to assess Value for Money (COLL 6.6.20R)

4.11 Our clients are concerned to ensure that the FCA's approach to this regulatory change is correctly understood by the regulator, the industry and investors. The FCA is seeking to introduce a new duty to conduct a Value for Money assessment (at least annually) (COLL 6.6.20R) and to report on that assessment to investors (COLL 4.5.7(8)). As above the FCA is not seeking to impose an underlying duty to deliver Value for Money.

4.12 However on that basis our clients are concerned by the proposed wording of COLL 6.6.20R which states:

"An authorised fund manager must conduct an assessment at least annually of whether each scheme it manages provides ***good*** *value for money for unitholders"* [emphasis added].

4.13 As drafted, the FCA appears to be seeking to impose a duty to deliver good Value for Money, rather than a duty to conduct an assessment. The proposed wording of COLL 6.6.20R and COLL 8.5.17R(1) state that an authorised fund manager must conduct an annual assessment of *"whether each scheme it manages provides good value for money"*. We suggest that the FCA should rephrase this duty to reflect its intention (and the actual consultation question posed[4]):

"An authorised fund manager must conduct a value for money assessment at least annually for each scheme it manages".

4.14 The duty proposed by the FCA is a duty to conduct the Value for Money assessment and to report on that assessment, not to ensure the outcome is *"good"*. Our clients are concerned that the introduction of this abstract concept (which could be interpreted as a subjective or objective test) is unhelpful, increases uncertainty and could result in the imposition of a higher duty than intended by the FCA. We request that the word "good" is deleted.

4.15 Our clients' concerns in this respect also extend, for the same reasons, to the introduction of the concept of *"poor value for money"* at COLL 4.5.7(8)(f)R, COLL 6.6.23E, 8.3.5A R (5)(f) and 8.5.19E. We request that the word *"poor"* is deleted.

4.16 Our clients are concerned that this terminology will lead to performance regulation by the back door, rather than promoting good customer outcomes through increased accountability of authorised fund managers and promoting the ability of investors to conduct a meaningful comparison between competitor funds. We are concerned that the FCA's current approach to Value for Money seeks to impose an absolute obligation to deliver Value for Money, rather than requiring firms to put in place appropriate systems and controls to deliver compliance with a regulatory rule (i.e. to conduct an assessment of

[4] Question 1: *Do you agree that we should introduce a specific rule requiring AFM boards to assess value for money?*

Value for Money and report to investors). It is unclear to our clients why the FCA is adopting such a fundamentally different approach in respect of this initiative.

<u>The Value for Money considerations (COLL 6.6.21R)</u>

4.17 In our response to the Interim Report MS15/2.2, we set out various factors which will impact "perceived value" for investors including:

(A) the stage of the assessment within the product lifecycle;

(B) the product itself;

(C) the distribution chain;

(D) the market environment; and

(E) the investors' objectives[5].

4.18 Our clients remain concerned that the Value for Money criteria outlined by the FCA (paragraphs 3.26 to 3.29 of CP17/18 and COLL 6.621R) are still very cost centric. Even the "Quality of Services" criteria, as defined by the FCA, is focussed on an assessment of the "level of charges" for services which are commensurate. The FCA does not appear to have addressed our clients' concern that the factors which inform an investor's view of Value for Money might be subjective, will change over time and might not be capable of quantification in monetary terms.

4.19 Our clients therefore request that the FCA amends the Value for Money considerations proposed at COLL 6.6.21R. At present this section is drafted as a Rule rather than Guidance which is unusual for a set of "considerations". Our clients would prefer this section to be drafted as Guidance, provide a non-exhaustive list of considerations and to include the following additional items:

(A) the type of product, portfolio or asset class which is being assessed – this would provide firms with the flexibility to assess different types of products in the most suitable way and to have reference to the objectives of each product;

(B) the longevity of the product – this would provide firms with the flexibility to assess products at different stages of the product lifecycle or to take into account the time horizon of a product;

(C) the risk profile of the product - this would provide firms with the flexibility to assess products with different risk profiles;

(D) the relevant market factors - this would provide firms with the flexibility to assess products in the context of relevant market factors for example commercial bargaining power with service party providers; or

(E) other factors which influence investor choice – this would recognise other relevant factors which impact investor choice such as factors at the point of sale, the quality of the distribution chain or additional services offered by an asset manager outside of the fund.

4.20 Whilst a number of these themes appear in COLL 6.6.22G they are listed in the context of *"assessing the appropriateness of charges and other payments.."* rather than in the more-

[5] Paragraph 5.7

specific context of the Value for Money assessment and we strongly believe that the criteria for the latter should be expanded, to take account of the more holistic factors referred to above which form part of good practice in terms of client service in the industry.

4.21 Our clients strongly believe that it is not possible to apply a one size fits all and exhaustive metric to measure and assess Value for Money across all asset managers. Our clients consider that a non-exhaustive list of considerations (provided as Guidance, not a Rule) would provide firms with the ability and flexibility to monitor and assess Value for Money in an appropriate way, which would then provide investors with information to make more informed investment decisions and conduct a more meaningful assessment of competitor offerings.

The role of an authorised fund manager board to assess Value for Money

4.22 We note that the amended COLL rules contained within Appendix 1 of CP17/18 do not specifically place the duty to conduct the Value for Money assessment on the board of an authorised fund manager (COLL 6.6.20R) but refers only to the authorised fund manager (as defined in the FCA Handbook[6]). However our clients are broadly supportive that, in circumstances where the FCA intends to introduce a duty to assess Value for Money, the board of an authorised fund manager is the appropriate forum to discharge this function. The membership of this forum demonstrates the necessary skill and expertise to deliver effective oversight of the business and operates within an appropriate corporate governance framework.

Do you agree with the planned implementation period of 12 months? If not, what alternative timeframe would you suggest?

4.23 Our clients are keen for the FCA to consider the wider regulatory context in assessing the appropriate time to introduce these new rules. In particular, our clients are strongly of the view that the new requirements to assess Value for Money should be delayed until after MIFID II, PRIIPS and the extension of the SM&CR are implemented and embedded. There is a perceived lack of clarity on how these new rules would interact without further guidance from the FCA.

4.24 Our clients consider that the timing of implementation is highly dependent on how quickly authorised fund managers are able to recruit the independent directors that the FCA requires as part of the new governance rules.

4.25 Our clients consider that 12 months is too short a period for the implementation of this process (depending on the proposed start of that process for the reasons outlined above). A more reasonable timetable would greatly assist implementation in a considered and orderly fashion with candidates for board positions of appropriate calibre.

Do you agree with the proposed requirement for the AFM to publish a report on the findings of the assessment and the steps taken?

The scope of the report

4.26 Our clients are concerned to ensure that the scope and content of the report on the Value for Money assessment is proportionate and will deliver the FCA's desired outcome of providing investors with information to make more informed investment decisions and conduct a more meaningful assessment of competitor offerings. As outlined above, our

[6] *an ACD, an authorised contractual scheme manager or an authorised unit trust manager.*

clients are concerned that the FCA has overstated the duty to assess Value for Money, as a duty to deliver good Value for Money or avoid poor Value for Money.

4.27 Our clients consider that the duty should be to report on *how* the fund manager has assessed value for money for investors as a whole, not *whether*. It seems wrong to impose on authorised fund managers higher standards than directors under company law. Directors are not required to report on whether they have maximised the success of the company or fulfilled its purpose. Neither, like Value for Money, are absolutes capable of objective assessment after the event. The relevant directors' duty in company law requires that: "*A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.*" The discharge of that responsibility will be a matter of commercial assessment.

4.28 Whilst our clients consider that it would be appropriate for the Value for Money report to include a statement setting out a description of the Value for Money assessment process (as required by COLL 6.6.20R, as restated at paragraph 4.13 above) and the corporate governance framework in place to deliver this process, this should not extend to requiring the authorised fund manager board to opine on whether it provided "good" or "poor" Value for Money.

4.29 Our clients are concerned by the level of granularity proposed in COLL 4.5.7(8)R and COLL 8.3.5AR which require "*a separate discussion and conclusion on value for money for each paragraph of COLL 6.6.21R…"*. Our clients consider that the requirement to conclude on whether Value for Money was delivered would go beyond the scope of the new duty which the FCA is currently consulting on (i.e. the duty to assess and report).

<u>Confidentiality</u>

4.30 Our clients have expressed serious concern about the confidentiality issues which might arise as a result of the granular reporting envisaged by the FCA in respect of charges and payments to service providers and the quality of services provided by service providers (COLL 4.5.7(8)R, COLL 6.6.21R, 6.6.22G and COLL 8.3.5A).

4.31 Whilst our clients accept that the FCA should have access to such sensitive commercial and confidential information (which will be protected by statutory confidentiality in the hands of the FCA) our clients are concerned with making this information publicly available. A number of our clients expressed concern that this disclosure would be contrary to the non-disclosure and confidentiality clauses contained within existing agreements with service providers. In addition, our clients are concerned by the concept of publicly opining on the "quality of service" received from service providers, how this would impact ongoing commercial relationships and that it would give rise to significant litigation risks.

4.32 Our clients consider that a more focussed approach to the reporting process which focuses on the evaluation process and the corporate governance around the assessment would be more aligned with the existing "40 Act" model in the US. These rules require directors to request and evaluate information which is reasonably necessary to assess service provider contracts and fees, and places an obligation to provide that information on the service provider.

4.33 Whilst our clients agree that it would be appropriate to report on the evaluation process and the corporate governance framework in place in order to demonstrate compliance with COLL 6.6.20R, they remain concerned by any requirement to:

(A) opine on whether, as matter of fact, a fund has provided "poor" or "good" Value for Money; or

(B) disclose commercially sensitive information about or opine on the quality of service party providers.

5. **Governance**

Do you agree with our proposal to require AFMs to appoint independent directors to the board? If not, what alternative(s) would you propose?

5.1 The general consensus amongst our clients is that introducing independent directors for authorised fund manager boards would represent a positive step and will help to deliver and demonstrate compliance with the duty to assess Value for Money and the reporting requirements. Our clients consider that having independent directors on the board of an authorised fund manager would increase the level of corporate governance for the benefit of investors.

5.2 We are concerned that the directors (whether independent or not) of an authorised fund manager will not want to be in a position where they discharge their duty to act honestly, fairly and professionally in accordance with the best interests rule but be open to that commercial judgement being second guessed retrospectively as part of the assessment of Value for Money (and in the case of the Senior Manager, being at risk of individual accountability).

Do you agree with the proposed proportion of independent directors (at least two and not less than 25% by number)?

5.3 Our clients consider that the prescribed proportion (25%) of independent directors appears to be arbitrary and unnecessary. Our clients considered that firms should have flexibility to assess their own requirements for both independent and executive directors and the FCA should amend the proposed rule to require a minimum of one independent director only (COLL 6.6.25R). Our clients were of the view that it is sufficient that the rules require at least one independent director, with authorised fund managers having the flexibility to appoint additional independent directors to the extent they consider it necessary or appropriate.

5.4 Our clients were concerned that having such a prescriptive requirement (25% proportion) would have a disproportionate impact on the costs to be borne by authorised fund managers. This will be especially important for smaller asset managers. Our clients were concerned that this requirement might lead to “a race” to hire independent directors, potentially making the “best” independent directors more expensive.

5.5 As we outlined at paragraph 5.17 of our response to the Interim Report these obligations will increase the costs of compliance; the cost of hiring independent directors (especially in a specialist market), the operation of additional meetings and increased reporting costs is likely to be borne by the fund and as such these costs will ultimately be passed on to the investors, thereby reducing returns.

Do you agree with our approach that independent directors may serve on more than one board, provided that they comply with existing rules? If not, do you think a ban on serving on more than one board is necessary?

5.6 The FCA recognises the tension between the requirement to share market sensitive and confidential material with independent directors and allowing independent directors to serve on the board of more than one directly competing authorised fund manager. Our clients considered that firms should have the autonomy to manage and mitigate these issues. Our clients agreed that they should be allowed to make their own assessment as to whether or not conflicts of interest were manageable (as detailed at COLL 6.6.2(2)R).

However, it should be noted that these conflicts might be more difficult to manage in practical terms with regard to the individual holding the new Prescribed Responsibility (see paragraph 5.14 below).

5.7 Our clients consider that they already have systems and controls in place to conduct sufficient due diligence and to identify and mitigate any potential conflicts of interest (as required by SYSC). Our clients felt confident that they would not appoint an independent director if they were concerned with other appointments that he or she has taken up with direct competitor funds.

5.8 However, it was suggested that it might be appropriate for independent directors to undergo training on corporate/competition law in order to understand how to identify and mitigate the risks and any potential unmanageable conflicts of interest which might arise.

Do you agree with the proposed requirements for being an independent director? If not, what alternatives do you propose?

5.9 The proposed requirements of independence at COLL 6.6.25R(3) and 8.5.20R(3) contemplate that these independent directors will have the experience *"to be able to make judgements on whether the authorised fund manager is managing each scheme in the best interests of unitholders"*. This purports to set out a different test than the obligations articulated under COBS 2.1.1 and Principle 6 which do not require this judgment to be made.

5.10 We raise a number of additional points in respect of the proposed independence requirements:

(A) we consider that the test at COLL 6.6.25R(3) and 8.5.20R(3) should be drafted with reference to "*the best interests of unitholders <u>as a whole</u>" (emphasis added);*

(B) could the FCA clarify whether the maximum duration of ten years applies only to new appointments after the proposed new rules come into effect?

(C) please note that independent directors are not necessarily *"employed"*, they are *"employed or appointed"*;

(D) it is not clear what the FCA intend by *"terms which secure their independence"*. We note that this additional requirement is not necessary as it should already be addressed within the requirement of *"independent in character and judgement"*;

(E) whilst we agree that independent directors should have sufficient "knowledge, skills and experience", we do not consider that it is appropriate the add "expertise". The introduction of the concept of expertise goes further than the Corporate Governance Code's requirements for independent directors which require *"appropriate balance of skills, experience, independence and knowledge*"[7];

(F) the test of whether an individual has received any remuneration from within the authorised fund manager's group should allow for the payment of director's fees;

(G) we are concerned that the test that an independent director must be free to act solely in the interest of unitholders potentially conflicts with company law. Under company law a director cannot act "solely" and has broader duties to consider

[7] https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf.

including various statutory factors (for example when insolvency is near and steps must be taken to prioritise the interests of creditors). We would therefore suggest that this test is refined by:

(1) inserting *"subject to their general duties as directors"*;

(2) the test should not be expressed as *"solely"* ; and

(3) the test should refer to unitholders *"as a whole"*.

(H) we are concerned that the obligation to fill any vacancies in any event within 6 months is not possible to mandate. We suggest that it should be qualified to "every effort" should be made; and

(I) the proposed rule that authorised fund managers should consider indemnifying independent directors should be qualified to include *"so far as the law allows"*. Company law restricts such indemnities to certain qualifying indemnities against 'third party' liabilities, not all liabilities (including to the company). Authorised fund managers should also consider the need for appropriate insurance for independent directors.

Do you agree with an implementation period of 12 months? If not, how much time do you think AFMs will need to appoint suitable independent directors?

5.11 For the same reasons as detailed above at paragraphs 4.23 and 4.25, our clients consider that 12 months is not sufficient for the implementation period. Our clients are concerned by the recognised shortage of independent directors in the UK, which would be further exacerbated if the FCA maintains its prescriptive approach to independent directors (2 independent directors and 25% proportion of the authorised fund manager board).

5.12 The FCA needs to recognise that the changes it proposes are substantial and that the task of finding and appointing the appropriate individuals with the industry knowledge and experience to fill such significant roles will take time. We note that other significant initiatives of this nature (for example the Davies Review of Women on Boards[8] demonstrates the time it takes to deliver such key initiatives in a sustainable way (12.5% to 25% female representation in 5 years on FTSE 100 boards)).

Do you agree that it should be up to AFMs to decide whether to appoint an independent director or an executive director as chair?

5.13 There appears to be confusion in the industry as to whether the FCA intends that the Chair of an authorised fund manager board should be an independent director or an executive director. CP17/18 appears to suggest that this role would only be held by an independent director[9], whilst CP17/25 (in respect of the extension of the SM&CR) appears to envisage flexibility with the Prescribed Responsibility being allocated to an independent director or an executive director. Our clients consider that it would be most appropriate to allow firms to decide how this role should be filled and by whom. Therefore the approach in CP17/25 is favoured by our clients.

5.14 However a number of our clients expressed concern that the increased regulatory exposure of the Prescribed Responsibility and the level of detailed business knowledge needed to discharge the responsibility of the Value for Money assessment and report

[8] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/482059/BIS-15-585-women-on-boards-davies-review-5-year-summary-october-2015.pdf

[9] Paragraph 3.48

would likely make independent director candidates reluctant to take on the role of Chair unless the role was suitably substantive and remunerated.

5.15 As raised in paragraph 5.17 of our response to the Interim Report, our clients queried whether independent directors would be willing to accept this level of responsibility and be able to provide such a large time commitment (which would likely limit the number of appointments which an independent director could hold and discharge comfortably).

5.16 We note that under proposed COLL 6.6.26G(2) the role of independent directors is articulated as one to provide *"input and challenge"*. This is more consistent with the role of a non-executive, but could still be part of the role of an executive. Whether or not an executive or non-executive *"input and challenge"* is a function of testing how the Value for Money framework is delivered in practice, however it should be noted that it is not consistent with the increased individual accountability which would be required of a Senior Manager performing the new Prescribed Responsibility.

6. Overlap with the extension of SM&CR

6.1 We consider that the governance proposals outlined in CP17/18 need to be read alongside the proposals for the extension of the SM&CR.

Limited Scope Firms

6.2 Our clients are concerned by how the FCA intends to address authorised fund managers who would be classified as Limited Scope Firms:

(A) how would the obligation to assess Value for Money be delivered by a Limited Scope Firm who fall outside the scope of the SM&CR and are therefore not required to have Senior Managers?

(B) would a Limited Scope Firm still fall within the scope of proposed COLL governance requirements?

6.3 Our clients are concerned that imposing these significant COLL governance requirements on Limited Scope Firms would be disproportionate, impractical and costly.

Scope of the Prescribed Responsibility

6.4 Our clients also note that the FCA's articulation of the Prescribed Responsibility has significantly changed. The relevant Senior Manager would be:

(A) *"responsible for taking "reasonable steps" to ensure the [authorised fund manager] and its board adheres to our current and proposed rules"* (CP17/18);

(B) *"[responsible] for an [authorised fund manager's] value for money assessments, independent director representation and acting in investors best interests"* (CP17/25)

6.5 Our clients note that the scope of the new Prescribed Responsibility is significantly broader than originally envisaged under CP17/18.

Timing of the SM&CR

6.6 The timetable for the extension of the SM&CR across the asset management industry is still unknown and subject to consultation CP17/25. Our clients would urge the FCA to consider how these two agendas are delivered in an effective and joined up way. The new Prescribed Responsibility proposes to introduce a new role, which will require significant implementation; rather than the other functions covered in CP17/25, which are better understood from the banking regime. The FCA needs to ensure that the recommendations of CP17/18 are delivered in parallel, or after, to avoid confusion should this “role” be required before the SM&CR is actually extended to relevant firms.

28 September 2017