

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:

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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 as set 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&CR¹. 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).
- 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.

¹ See DP16/4, paragraph 3.21

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. **Flexibility to allocate overall responsibility**

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.

Structure

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”.

General Counsel

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.

Separation between management and legal advice

- 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.

The FCA's approach to LPP

- 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 it².
- 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 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

² See DP 16/4, paragraph 3.27

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 in-house 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 SC4³ 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 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

³ SC4: *You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice*

to act with due skill, care and diligence?

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