

Possible effects on in-house lawyers of the new regime for individual accountability in banking

The new regime for individual accountability in banking is likely to apply to in-house lawyers in two key respects:

- (a) the conduct rules created by the PRA and FCA (Conduct Rules) will apply to in-house lawyers; and
- (b) the Senior Manager regime may (although we understand the FCA considers it should not) also apply to the person with overall responsibility for the legal function within a bank.

Both raise potential issues for in-house lawyers, particularly when set against their existing professional obligations, which will continue to apply. This note considers such obligations in the context of solicitors, although many of the fundamental principles will also apply to barristers.

Conduct Rules

In-house lawyers are not among the 20 categories of employees who will be exempt from the application of the Conduct Rules. This is, in itself, an interesting omission for at least the following reasons:

- (a) lawyers are already subject to professional regulation;
- (b) solicitors regulated by the SRA who would otherwise be carrying out regulated activities within the meaning of FSMA are deemed to be carrying out exempt regulated activities because the SRA is a designated professional body (Part XX FSMA)¹; and
- (c) the FCA's explanation of the 20 categories of exempt employees is that their role would be fundamentally the same were they not working at a financial services firm. It is not obvious why this should not also apply to some in-house lawyers at a financial service firm.

In view of the large numbers of secondees provided by firms of solicitors in particular to client banks, it is worth noting that the Conduct Rules (while expressed to apply to employees of relevant financial services firms) are also likely to apply to solicitors and barristers seconded from private practice. This is because of the definition of "employee" for the purposes of the Conduct Rules, in section 64A(6) of FSMA. According to that definition, an employee includes anyone obliged to provide personal services to the firm, whether by an agreement between that person and the firm, or between the firm and another person. The individual will also need to be subject to the supervision, direction or control of the firm in order to be classed as an employee.

The SRA has created a Handbook for regulation, which is similar in form to the FCA Handbook. It includes a list of Principles to which solicitors must adhere, together with more detailed conduct rules. The SRA's Principles are set out below, together with the new Conduct Rules.

¹ The exemption under Part XX does not extend to barristers.

| SRA Principles | Conduct Rules | |
|--|-------------------------------------|---|
| Uphold the rule of law and the proper administration of justice | CR1 | You must act with integrity |
| Act with integrity | CR2 | You must act with due skill, care and diligence |
| Not allow your independence to be compromised | CR3 | You must be open and co-operative with the FCA, the PRA and other regulators |
| Act in the best interests of each client | CR4 | You must pay due regard to the interests of customers and treat them fairly |
| Provide a proper standard of service to your clients | CR5 | You must observe proper standards of market conduct |
| Behave in a way that maintains the trust the public places in you and in the provision of legal services | Senior Manager Conduct Rules | |
| Comply with your legal and regulatory obligations and deal with your regulators and ombudsmen in an open, timely and co-operative manner | SM1 | You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively |
| Run your business or carry out your role in the business effectively and in accordance with proper governance and sound financial and risk management principles | SM2 | You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with relevant requirements and standards of the regulatory system |
| Run your business or carry out your role in the business in a way that encourages equality of opportunity and respect for diversity | SM3 | You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the delegation of responsibility effectively |
| Protect client money and assets | SM4 | You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice |

Looking specifically at the Conduct Rules that will apply to all employees, there may be some limited scope for conflict.

Chapter 4 of the SRA Code of Conduct, in relation to confidentiality, expressly applies to in-house lawyers. It provides (in essence) that protection of confidential information is a "fundamental feature" of the relationship between solicitor and client. It is possible that this obligation might conflict with the requirement in the Conduct Rules to be open and co-operative with the FCA, PRA and other regulators. The guidance to this Conduct Rule in the proposed C-CON sourcebook is largely, but not entirely, reassuring for in-house lawyers in that it states that:

- (a) There is no positive obligation to report to the regulators unless the employee concerned is one of the persons within the firm specifically charged with doing so. However, if the employee takes steps to influence a decision not to report to the regulator, then the regulator will view him or her as having taken on responsibility for whether or not to report². This may be of potential concern to an in-house lawyer advising that a report does not need to be made, which might in turn create a conflict of interest between the solicitor and the client firm (as to which see below).
- (b) It will be a breach of the Conduct Rule if an employee fails, without good reason, to supply the regulator with information or documents when asked to do so³. The guidance in C-CON states that good reason will include the maintenance of legal professional privilege⁴, although in practice, firms may well need to waive privilege in order to demonstrate that they have taken reasonable steps to comply with the rules.

Conduct Rule 4 requires employees to pay due regard to the interests of customers and treat them fairly. Most, but not all, of the C-CON guidance is directed at those who have direct dealings with customers, but the following may be of interest to in-house lawyers:

- (a) It is an example of a failing under this rule to fail "*to acknowledge or seek to resolve mistakes in dealing with customers*"⁵. For in-house lawyers who consider customer complaints, this raises the possibility of personal culpability in terms of the advice given and action taken, if the FCA does not agree with it. For example, an in-house lawyer may advise that there are some defects in the sale of a derivative product to a customer but that, on balance, the customer's claim for compensation should be refused. Alternatively the lawyer may advise that because the customer had not clearly identified these defects as being responsible for his or her decision to purchase the product, the firm should defend any claim before offering any financial settlement to the customer on the basis that this may result in a more favourable outcome for the firm. Does that lawyer breach the Conduct Rules if he or she does not advise the firm to confess to mistakes identified and offer compensation forthwith?
 - (i) As a result of their existing professional obligations, lawyers in this position would be obliged to provide the advice they thought best to their client employer, in order to provide a proper standard of service and act in the client's best interests. Such advice might well include advice that the firm comply with DISP in respect of its handling of the complaint. However, DISP does not specifically require firms to acknowledge mistakes in their dealings with clients, albeit that it requires them to assess a complaint fairly and diligently.
 - (ii) It should be the case that, on a sensible interpretation, the FCA does not require of individuals under C-CON any greater standard than is required of firms under DISP. However, in-house lawyers dealing with complaints (particularly those in areas where there is a possibility that widespread misselling may be alleged) might wish to consider the FCA's guidance, and it is not clear how it will be applied.
- (b) It is also an example of a breach of Conduct Rule 4 to fail to provide terms and conditions to which a product or service is subject in a way which is clear and easy for the customer to understand⁶. There are various points to make in relation to this guidance.
 - (i) It would seem a peculiar step by the FCA to bring enforcement action against the individual draftsman of a set of terms and conditions on the basis that they were insufficiently comprehensible.

² C-CON 4.1.10G

³ C-CON 4.1.11G

⁴ C-CON 4.1.12G

⁵ C-CON 4.1.14(6)G

⁶ C-CON 4.1.14(7)G

- (ii) It is, however, difficult to understand what the guidance means otherwise. The only other possibility is that the FCA says it might take enforcement action against a salesman whose only action is to hand over a set of poorly drafted terms and conditions, which seems equally odd.
- (iii) This guidance goes beyond the requirements of COBS 2.2 (information must be comprehensible, so that the client is reasonably able to understand) and COBS 4.2 (fair, clear and not misleading).
- (iv) If the in-house lawyer's drafting is so poor that it is incomprehensible, it is conceivable that the SRA would view that as a failure to provide the firm with a proper level of service. However, it seems unlikely that the SRA would take the view that drafting had to be "easy to understand" in order not to be negligent.

It will be interesting to see how these pieces of guidance are applied, but they raise the possibility that the FCA will find behaviour which is entirely proper according to professional rules to be a breach of the Conduct Rules.

Senior Manager rules

In relation to Senior Managers, there are two questions to ask:

- (a) whether the new Senior Manager rules apply to in-house lawyers; and
- (b) if they do, whether there is any greater scope for conflict between the regulatory regimes applicable to in-house lawyers who are also Senior Managers.

Do the Senior Manager rules apply?

There is no requirement that overall responsibility for the legal function within a bank be allocated to the holder of a Senior Management Function⁷. Nor is there any express provision that the person with overall responsibility for the legal function performs a controlled function (and will therefore be a Significant Responsibility SMF on that basis)⁸.

There are therefore two possible routes by which such a person would come to be the holder of a Senior Management Function:

- (a) If he or she held such a function for some other reason- the person with overall responsibility for the legal function may have other responsibilities. For example, he or she might be responsible for collections and recoveries. In that case, such a person would be performing a controlled function and be a Significant Responsibility SMF⁹.
- (b) By reason of category (3) of Part Two of the table at SYSC 4.5.16R ("the Category (3) Requirement"), which relates to "*The function of having overall responsibility for any other activities, business areas or management functions of the firm*". There is no guidance as to what the Category (3) Requirement actually means, beyond a statement that "*Anyone having overall responsibility for any function of a firm will be performing an FCA controlled function, as explained in SYSC 4.5.26G*". On its face, the requirement appears broad enough to cover the individual with overall responsibility for the legal function within a firm.

⁷ SYSC 4.5.16R and 4.5.25R (1)

⁸ SYSC 4.5.16R, 4.5.25R (2) and 4.5.26G (2)

⁹ See SYSC 4.5.26G and SUP 10C.3.2G (and SUP 10C.4.3R)

If the Category (3) Requirement is to be interpreted as broadly as it appears, there may be further reasons why the person with overall responsibility for the legal function would not require approval as a Senior Manager. The definitions of Senior Manager in s59ZA of FSMA, the Glossary and SUP 10C.3.8G all provide that a function is a Senior Management Function (if the relevant conditions are met) in relation to the carrying on of a regulated activity by a firm.

It is difficult to reach a firm conclusion as to how that definition affects the question here. On one view, the provision of legal services is not a regulated activity within the meaning of financial services legislation. Considered on that basis, having overall responsibility for that function cannot come within the definition of a Senior Management Function. However, there are at least two possible arguments against that interpretation.

- (a) Some legal services provided by in-house lawyers might themselves be regulated activities, although others will certainly not. One example might be the regulated activity of arranging deals in investments under Article 25 of the Regulated Activities Order 2001¹⁰.
 - (i) Where such activities are carried out by solicitors in private practice, they are exempt regulated activities under Part XX of FSMA (referred to above), but the position in relation to in-house solicitors is not clear. Under s327 of FSMA, it appears that any individual solicitor regulated by the SRA is exempt in some cases from the general prohibition at s19 of FSMA regardless of where he or she is employed. However, the Financial Services (Scope) Rules (created by the SRA to regulate the way and extent to which solicitors carry out exempt regulated activities) do not appear to apply to in-house solicitors, and are drafted on the basis of requirements made of firms.
 - (ii) In any event, the question of whether or not the exemption in Part XX of FSMA applies only really goes to liability under the general prohibition. A regulated activity is still regulated, and it therefore seems likely that the person with overall responsibility for any regulated activities performed by in-house lawyers would be performing a controlled function under the amended SYSC and SUP rules.
- (b) Even where the legal services provided are not themselves regulated activities, they may relate to the performance by the firm of regulated activities. It may be that the FCA would ask the court to adopt a broad approach to the definition in s59ZA of FSMA, such that activities ancillary to the firm's performance of a regulated activity were also covered. While there is case law dealing with the court's interpretation of regulated activities, it is not possible to predict what view it would take of an argument of this kind.

We understand that the FCA takes the view that the person who reports to the board in relation to the legal function does not have "overall responsibility" within the meaning of the new rules in SYSC 4.5, in that the legal function exists to advise rather than having any operative business purpose. In other words, the person responsible for the legal function is not a decision-maker. The feedback we have on this from senior lawyers in banks is that this view is welcome (and certainly not something they are looking to challenge) but perhaps unrealistic given their remit. In particular, this view seems to us to be divorced from how the rules apply for (at least) the following reasons:

- (a) the new rules apply to those with overall responsibility, as the rules define it;
- (b) the guidance at SYSC 4.5.19G to SYSC 4.5.24G suggests strongly that the FCA does not equate overall responsibility with decision-making power;
- (c) the failure to exempt in-house lawyers from the Conduct Rules suggests that the FCA does not view them as a purely ancillary function; and

¹⁰ In relation to this specific example, there is extensive guidance in PERG 2.7 and in the judgment to which it refers as to the FCA's and the court's view of what amounts to arranging deals in investments (e.g. back office staff who document a transaction already concluded do not carry out a regulated activity).

- (d) such a view would ignore the fact that the person ultimately responsible for the legal function within a bank is frequently also a member of numerous other committees, and may have considerable influence on the bank's decision-making.

For these reasons, it is difficult to reach a settled view as to whether the new Senior Manager rules require the person with overall responsibility for the in-house legal department of a bank to be a Senior Manager. It may be safest to work on the basis that they do, although there are good arguments to the contrary.

What conflict might there be between the Senior Manager rules and professional rules?

The comments below are predicated on the Senior Manager with overall responsibility for the legal function being a lawyer (and are drafted on the basis that such person is a solicitor). If this is not the case, then there is obviously no likelihood of conflict.

It is also worth noting that if the relevant person is a Senior Manager for some other reason (e.g. because he or she carries out a PRA Prescribed Responsibility or an FCA Key Function), then the Senior Manager Conduct Rules will apply to his or her activities in relation to the legal department, irrespective of the points made above as to whether its activities can ever be said to be regulated or not. The Conduct Rules expressly apply to unregulated as well as regulated activity¹¹.

The Conduct Rules applicable to virtually all employees are also applicable to Senior Managers. However, as set out in the table above, there are additional Conduct Rules applicable only to Senior Managers. For present purposes, the Conduct Rule which is most likely to create a conflict with the Senior Manager's professional obligations as a solicitor is SM4: "*You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice*". The guidance on this rule is instructive.

In C-CON 4.2.25G to 4.2.29G, the FCA distinguishes between this rule and Conduct Rule 3 (referred to above). SM4 imposes a positive duty on Senior Managers to notify the regulators of information in respect of which the regulators would reasonably require disclosure, if (according to the responsibilities map) such information falls within the Senior Manager's scope of responsibility. Where it does not fall within his or her scope of responsibility, the Senior Manager is supposed to make enquiries to find out whether the matter is being dealt with by the responsible Senior Manager, if he or she cannot assume that it is.

The FCA sets out a list of three criteria it will use in order to determine whether a person's conduct complies with SM4. Those criteria do not include any assessment of whether the Senior Manager in question had a legitimate reason not to disclose the information. When contrasted with the guidance in relation to Conduct Rule 3, the omission of any acknowledgement that legal professional privilege might be a good reason for not making a notification is striking.

If the omission is taken at face value, its consequences are potentially serious. If a legal concern, for example in relation to whether the firm has sold a product in a compliant way, is considered by the firm's legal department and is considered to be of sufficient seriousness that it is escalated to the person with overall responsibility for reporting to the board on legal matters, then that person could not fail to draw it to the FCA's attention solely on the grounds of legal professional privilege. That consideration might also extend to details of the legal advice given to the bank as to its position.

If this is the case, then such a requirement of the Senior Manager would be at obvious odds with his or her professional obligation as a solicitor to keep information confidential (and potentially the obligation to act in the client's best interests). Such a conflict between the firm's and the Senior Manager's interests would also be a breach of the SRA's requirement of solicitors not to act in any case where there is a conflict between them and their client. It is not clear, however, how a solicitor in the position of the Senior Manager could cease to act.

¹¹ C-CON 1.1.6R

It may be that firms could argue that the FCA could not reasonably require notice of privileged matters. However, it is possible to envisage a scenario (e.g. where there is a dispute between the view of the in-house department and external lawyers as to whether a particular sales technique is compliant) where the FCA might say that it required notice of the existence of a dispute and the firm's position.

It may be that firms would be best advised to structure responsibilities in such a way that the person with overall responsibility for the legal department is not a lawyer. There seems no reason why General Counsel, for example, could not report to a board member, who would have ultimate reporting responsibility to the board. This would prevent that Senior Manager:

- (a) facing any personal conflict in relation to the application of the Conduct Rules and the SRA's rules; and
- (b) ever giving advice that would be subject to legal professional privilege.

Enforcement

In the event that there is a conflict between the two regulatory systems, it is not clear whether either the FCA or the SRA would take action against an in-house lawyer where the breach that occurred took place in order to comply with the requirements of the other. If they did, it is not clear whether the other regulator would have an opportunity to intervene in the proceedings.

Even where the two systems do not conflict, it is not clear how enforcement proceedings would work. Annex 2 to the Enforcement Guide sets out guidelines on the investigation of cases of interest to the FCA and other prosecuting or investigating agencies. However, the guidelines apply to a specified list of other agencies, which does not include the SRA.

There is a Memorandum of Understanding in place between the FCA and the SRA, dated 27 March 2013, but while it provides for some sharing of information relating to investigations, it does not cover the issue of enforcement action being taken against an individual.