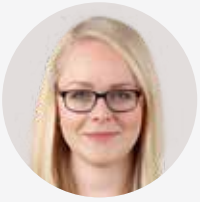
ALLEN & OVERY

# The interplay of reporting obligations, privilege and client disclosure for UK financial institutions

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A common question for many sanctions compliance professionals concerns the interplay between regulatory reporting requirements, legal privilege and disclosure obligations to clients. Sarah Hitchins and Jonathan Benson explore the issues from a UK perspective.


Financial institutions face a myriad of sanctions compliance issues arising out of the multiplicity of legal, regulatory and reporting regimes that they are subject to. For Financial institutions in the United Kingdom, the complexity of this sanctions compliance picture has been recently enhanced by two factors: the legal divergence between the UK and the EU since Brexit; and the increasing risk of enforcement since the establishment in 2016 of the Office of Financial Sanctions Implementation ('OFSI') within HM Treasury, which signalled a greater focus on financial sanctions compliance.

It is important that Financial institutions in the UK understand the various sanctions-related reporting obligations they are subject to, and how and when to engage with clients in relation to sanctions compliance issues. It is also important to understand the impact that legal privilegerelated considerations may have when considering these issues.

## When do financial institutions have to report to the regulators?

### Overview of financial sanctions

Financial sanctions are one type of sanction that can be imposed by governments and international organisations to achieve specific policy objectives. Financial sanctions come in many forms, but common types include:

– asset freezes, which can apply to both individuals and entities restricting their access to funds and economic resources; and

– restrictions related to a variety of financial products and services, which can apply to named individuals and entities, specific services or products, or entire sectors.

In the UK, the list of persons expressly targeted by asset freezes can be found on OFSI's consolidated list of financial sanctions targets, available online.[1] The UK also imposes a range of other financial sanctions, for example, restrictions on the granting of certain forms of loans and credit to certain Russian companies and some of their affiliates.

### Background to the current UK sanctions regime

Prior to the end of the Brexit-related implementation period with the EU (11 pm GMT on 31 December 2020), the UK's sanctions regime was principally comprised of EU regulations, which imposed sanctions and had direct effect in the UK, and UK secondary legislation that created the associated enforcement framework in domestic law.

Following the end of the Brexit-related implementation period, the UK has an autonomous sanctions regime. In 2018, the UK passed the Sanctions and Anti-Money Laundering Act 2018, which allows the UK government to make sanctions regulations for a range of purposes ('Sanctions Regulations'). Those Sanctions Regulations came fully into force at the end of the Brexit-related implementation period.

The Sanctions Regulations broadly replicate the EU regimes that they replaced and carry across the reporting requirements that were set out in the UK regulations – although, there are now some UK specific regulations, such as the Global Human Rights, and Global Anti-Corruption regimes.

### OFSI reporting requirements

The Sanctions Regulations impose certain reporting obligations on 'relevant firms'. Of particular relevance, a 'relevant firm' includes Financial institutions that are authorised under Part 4A of the Financial Services and Markets Act 2000 ('FSMA') (permission to carry on regulated activity). Other 'relevant firms' include currency exchange offices; auditors; a firm or sole practitioner that provides accounting services, legal or notarial services, advice about tax affairs, or trust or company services; a firm or sole practitioner that carries out estate agency work; a casino; and a dealer in precious metals or stones.

The reporting provisions provide that a 'relevant firm' must inform OFSI as soon as practicable if:[2]

– It knows, or has reasonable cause to suspect, that a person (i) is a designated person or (ii) has committed an offence in relation to the UK's financial sanctions or associated licences.

– The information or other matter on which the knowledge or suspicion is based came to it in the course of carrying on its business.

Broadly speaking, a 'relevant firm' must provide (a) the information or other matter on which the knowledge or suspicion is based; and (b) any information it holds about the designated person by which the designated person can be identified.

Where a 'relevant firm' informs OFSI that it knows, or has reasonable cause to suspect, that a person is a designated person and that person is a customer of the 'relevant firm', the firm must also state the nature and amount or quantity of any funds or economic resources held by it for the designated person at the time when it first had the knowledge or suspicion.

In addition to the above reporting requirements, a 'relevant institution' (which means an FI authorised under Part 4A of the FSMA) must inform OFSI without delay if that institution credits a frozen account where it receives funds transferred to it for the purpose of crediting that account or if it transfers funds from a frozen account in a non-ring-fenced body to an account in a ring-fenced body (in accordance with the ring-fencing provisions under the FSMA). An institution does not need to inform OFSI when it credits an account with interest or other earnings due on the account.

It is an offence to fail to comply with the relevant reporting obligations, which may result in a criminal prosecution or a civil monetary penalty being imposed.

"Regulators and authorities are not shy about challenging what they perceive to be questionable claims to privilege."

[1] www.gov.uk/government/publications/financial-sanctions-consolidated-list-of-targets.

[2] See, for example, regulation 70 of the Russia (Sanctions) (EU Exit) Regulations 2019.

## What is legal professional privilege and why is it important?

### What is legal privilege?

Legal professional privilege has been described by the House of Lords as 'a fundamental human right' which is 'a necessary corollary of the right of any person to obtain skilled advice about the law' which cannot be effectively obtained 'unless the client is able to put all the facts before the adviser without fear that they may afterwards be disclosed and used to [their] prejudice.'[3]

Under English law, two categories of legal professional privilege are available: legal advice privilege and litigation privilege.

Legal advice privilege attaches to confidential communications between a client and its lawyers who are acting in their professional capacity for the dominant purpose of providing legal advice.

Litigation privilege attaches to confidential communications between lawyers and their clients, or lawyers or their clients and third parties that were created for the purpose of obtaining information or advice in connection with existing or contemplated litigation, if at the time of the communication in question:

– litigation is in progress or is reasonably in contemplation;
– the communications are made with the sole or dominant purpose of conducting that anticipated litigation; and
– the litigation is adversarial in nature, not investigative or inquisitorial.

### Asserting privilege in investigations: Navigating complexity and challenges

Whether legal advice and/or litigation privilege will apply in any given situation is fact-specific. Over the last few years, there have been no shortage of judgments where third parties, including regulators and authorities, have challenged firms' claims to privilege over information or documents that are relevant to their enquiries or investigations. A particular focus of a number of these judgments has been the extent to which information or documents that firms have generated in order to establish the facts of a particular matter with a view to seeking internal or external legal advice may be covered by legal privilege, as well as internal communications about matters that are subsequently the subject of an external investigation.

As a result, although privilege can provide firms with welcome protections in certain situations, it is vital that consideration is given to the extent to which privilege may apply to communications involving lawyers at the outset of a matter. Too often firms only turn to consider this issue once an internal investigation is already underway or an external investigation has been threatened or is on foot, by which point opportunities to consider how privilege may apply are likely to have been lost.

Privilege should not, however, be viewed as a blanket that automatically covers all communications involving internal or external lawyers.

Regulators and authorities are not shy about challenging what they perceive to be questionable claims to privilege over information that may be relevant to their enquiries or investigations. As a result, if a regulator or authority requests documents or information that a firm considers may be covered by legal privilege, care must be taken in order to ensure that any such assertions of privilege are properly made. For example, although the Sanctions Regulations provide that the reporting requirements do not apply to information to which legal professional privilege is attached, OFSI has stated that it expects legal professionals to ascertain carefully whether legal privilege applies and to which information. OFSI may challenge a blanket assertion of legal professional privilege where is it not satisfied that such careful consideration has been made.

### How to report to OFSI

*Firms should email reports of frozen funds and economic resources, information regarding a designated person, and notifications of credits to frozen accounts to:* ***ofsi@hmtreasury. gov.uk****. OFSI has developed a specialised form that firms should complete and submit regarding suspected breaches located at:* ***www.gov.uk/guidance/suspected-breach-of-financial-sanctions-what-to-do****.*

*Every year, OFSI carries out a review to update its records to reflect any changes to frozen assets during the reporting period. As part of this review, it requires all persons that hold or control funds or economic resources belonging to, owned, held or controlled by a designated person, to provide it with a report containing details of the assets.*

"If a firm considers that a matter should be reported, a common challenge is deciding when to report it."

[3] *R (Morgan Grenfell & Co Ltd) v Special Commissioner of Income Tax* [2002] UKHL 21.

# Factors to consider when reporting to UK financial services regulators

## Self-reporting obligations

In addition to their OFSI reporting obligations, Financial institutions operating in the UK must also comply with specific self-reporting obligations set by the UK financial services regulators, the Financial Conduct Authority ('FCA') and, if applicable, the Prudential Regulation Authority ('PRA'). Both the FCA and the PRA require Financial institutions that they regulate to 'deal with [their] regulators in an open and cooperative way, and… disclose to' the FCA and/or the PRA (as applicable) 'appropriately anything relating to the firm of which that regulator would reasonably expect notice' (FCA Principle 11, PRA Fundamental Rule 7). These are intentionally broad self-reporting obligations and compliance with them is not optional. Failure to comply with them can have serious consequences for firms and relevant individuals, including enforcement action.

Sanctions is a topic that is of interest to the UK financial services regulators. In particular, the FCA has previously taken enforcement action against firms for failing to implement and operate adequate systems and controls to counter bribery and corruption risks, including those arising from dealing with third parties who appear on or be connected with others who appear on sanctions lists. As of August 2020, the FCA has six enforcement investigations of this kind on foot.

Decisions as to whether and, if so, when firms should report sanctions-related matters to the FCA turn on their specific facts and specialist advice should be sought. If a firm considers that a matter should be reported, a common challenge is deciding when to report it. On the one hand, when an issue is first identified a firm may have very little information about it or what they are intending to do in order to address the issue. They may also be wary about misrepresenting the nature of the issue or the extent of it to a regulator. However, on the other hand, gathering all relevant information about an issue may take a considerable amount time, which may lead to firms being criticised for failing to report a matter to the FCA on a timely basis in accordance with FCA Principle 11. Firms usually try and strike a balance between these two extremes, opting to make appropriately caveated notifications to the FCA at an earlier stage on the understanding that they will provide updates as and when more is known about the relevant issue. Taking this approach does not guarantee that a firm will necessarily avoid the FCA using its supervisory or enforcement powers. However, giving careful consideration to interactions with the FCA and the timing of them may help to avoid aggravating an already potentially serious situation for the firm and any relevant individuals.

Separate to a firm's obligations to the FCA and the PRA, firms will also need to consider whether a particular set of facts gives rise to a reporting requirement to the UK's National Crime Agency under the UK's Proceeds of Crime Act 2002 ('POCA') or the Terrorism Act 2000 ('TA').

## Legal privilege considerations

The statutory powers bestowed upon the FCA to obtain information and documents from third parties to assist with the discharge of its statutory obligations do, however, have their limits. In particular, the FCA cannot use its statutory powers to compel a third party to provide them with information and documents that are privileged. This restriction is unlikely to prevent a firm from disclosing the facts of a sanctions-related matter to the FCA, but will provide protection against disclosure of any underlying legal analysis relating to the matter that is privileged.

If a firm considers that privileged information or documents may be of assistance to the FCA's enquiries in relation to a particular matter, the firm can consider whether it is prepared to provide information or documents on a 'limited-waiver' basis. This approach allows a firm to waive privilege over certain information or documents for a limited purpose (eg, to assist the FCA with its specific enquiries) without waiving privilege over them more generally. Adopting this approach can result in the FCA giving credit to a firm for cooperation (eg, a discount on any financial penalty that may be imposed as part of any enforcement action taken). If a firm is considering pursuing this strategy, care must be taken to ensure that it is deployed effectively. For example, specific wording must be used in order to make it clear that privileged information or documents are being provided on a limited-waiver basis and care should be taken to avoid any perception on the FCA's part that a firm is inappropriately 'cherry picking' what information it waives privilege over.

## Interest from international regulators and authorities

Many sanctions-related matters are unlikely to be confined to the UK. This means that firms must always give careful consideration to whether they may have any reporting obligations to regulators and/or authorities in other jurisdictions.

The FCA routinely shares information with regulators and law enforcement agencies in other jurisdictions and vice versa. As a result, firms should understand that information that they provide to the FCA may, for example, find its way into the hands of other regulators and/or authorities without them being aware that this information is being shared. Likewise, the Sanctions Regulations provide the UK government with considerable latitude to share information with other governments and international organisations.

If a sanctions-related matter arises in another jurisdiction, Financial institutions must consider if any UK reporting obligations are triggered. For example, the FCA and the PRA expect firms to notify them of certain matters arising in other jurisdictions that may have a nexus or impact on their UK business or any individuals (especially senior individuals) who work for them in the UK. Although they did not concern sanctions-related matters, the FCA and the PRA have taken enforcement action against firms and individuals for failing to notify them of matters arising in other jurisdictions in these kinds of situations.

## Sharing information with your clients: factors to consider

As breaching the UK's financial sanctions can have severe consequences, it is important that Financial institutions have appropriate compliance processes, procedures and systems in place. This is consistent with the FCA's requirements and expectations of Financial institutions that it regulates. This includes having clear processes to deal with the freezing of funds, cease transactions with designated persons, and to ensure that relevant information is reported to OFSI without undue delay.

Firms are not legally required to advise their clients of financial sanctions-related issues (eg, that their accounts have been frozen because they are a designated person), unless the firm is under a contractual obligation to do so. However, there may be various reasons why the firm wishes to engage with clients on financial sanctionsrelated issues, for instance as part of the due diligence process to confirm whether or not the customer is in fact a designated person. As part of their client management, firms may also wish to explain to clients that they are taking such measures due to the person being subject to an asset freeze and to outline the effects of any restrictions on them.

In respect of the UK's asset-freezing sanctions, as the UK's list of designated persons is publicly available, in principle, the freezing of funds or informing clients does not give rise to similar 'tipping-off' issues as can arise, for example, in the context of POCA. However, particular care will need to be taken where a designation is subject to a restricted publicity condition and, depending on the specific factual circumstances, there may be an interaction between the UK's sanctions regime and other legal regimes (such as the UK's anti-money laundering regime under POCA and the UK's counter-terrorist financing regime under the TA). As such, particular care will need to be taken to ensure that sharing information with clients will not cause compliance issues under other applicable regimes. This is consistent with the expectations of the FCA in this area.

## Conclusion

For Financial institutions, compliance with sanctions continues to be a priority area. It is important that Financial institutions have systems in place to ensure that when issues arise, and reporting obligations to regulators may be engaged, a response strategy can be quickly formulated. That response strategy is likely to involve early engagement with in-house counsel, external counsel and senior management, document preservation and identifying and implementing remedial measures. In many cases, when and how to engage with clients, regulators and other stakeholders will be an integral part of that response strategy. Ensuring and preserving legal privilege will be key. Clearly, strategic thinking, informed by legal advice at every stage after an issue is identified, will help to limit the adverse impact of any sanctions compliance issues that arise for Financial institutions.

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