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Client Alert

Financial Services Regulation Practice Group

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The Senior Managers Regime – should GCs be worried?

In March this year the PRA and the FCA introduced the Senior Managers Regime ('SMR') for individuals associated with banks and PRA regulated investment firms (from 2018 the SMR will apply to all UK authorised firms). The regime is designed to increase individual accountability of firms' senior managers by more clearly setting out the individual areas of responsibility attributable to each senior manager.

Following some pressure from the industry, in September, the FCA published a Discussion Paper (DP 16/4) in which they invite a debate as to whether the legal function should continue to be part of the SMR going forwards. The Discussion Paper sets out a number of arguments which principally concern the perceived threat to the independence of the legal function and the status of legal professional privilege posed by the SMR.

Ultimately, however, one might view the debate as being about whether lawyers should be treated any differently to other professionals who are engaged in the financial services industry. The Law Society has already been outspoken as to the threats it perceives from the SMR. The worry for them and for GCs and in-house lawyers is that the FCA decides that the answer to the question "are lawyers different?" is, unfortunately, "no".

With the grace period offered by the FCA to GCs potentially set to end, GCs across the financial services sector should think about what the SMR could mean for them.

Currently, the FCA requires the most senior person who is responsible for a bank or PRA-regulated investment firm's legal function to be pre-approved as a Senior Manager. This requires an assessment of the person's fitness and propriety by the regulator and subjects the individual to a "statement of responsibility" which sets out in detail the specific functions which the individual oversees. Statements of responsibility and the management responsibilities maps which

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accompany them provide the regulators with a key tool when looking to apportion individual responsibility for a regulatory breach or other misconduct. In addition, Senior Managers are subject to a "duty of responsibility" which means they must take reasonable steps to prevent regulatory breaches in the areas of the firm for which they are responsible. A Senior Manager can be guilty of misconduct if they have failed to take such steps.

The SMR does not refer to the legal function or to General Counsel specifically and the FCA acknowledges that the legislative and regulatory framework does not contain any requirement that the role of General Counsel or head of legal be designated as a Senior Manager. However, the FCA's approach, as set out in SYSC, requires that every part of a firm's activities should be captured by the SMR. Given that a firm's General Counsel is usually the most senior person responsible for the management of the legal function (and reports directly to the board on the operation of that function) and the legal function is regarded by the FCA as being a business function (because the FCA regards 'activity, business area or management function' as including everything that a firm does "*including internally-facing functions, such as legal*"), they will need to be approved as a Senior Manager. However, owing to some initial confusion as to the FCA's position, the FCA granted firms which had not included the legal function or General Counsel in their implementation of the SMR a grace period pending further consultation.

Owing to the distinct nature of the role of General Counsel (unless the GC is also the compliance officer – which in larger institutions is unlikely), for a UK firm, the individual will be required to be approved as an SMF18, i.e. a person with "Other Overall Responsibility". As a Senior Manager, the GC will be subject to prior regulatory approval before they can carry out their activities and they are also subject to an additional set of conduct rules which apply only to Senior Managers.

In addition to the SMR, the PRA and the FCA also introduced a "Certification Regime" and respective sets of conduct rules, which in the case of the FCA's 'COCON', apply widely. Therefore, even if a GC is not designated as a Senior Manager (for instance because the legal function falls under the ultimate supervision of the CFO or COO) the GC and the in-house legal team will still be subject to conduct rules and the GC (as a "material risk taker" under CRD IV) will, at a minimum, also have their fitness and propriety assessed by on an annual basis by the firm under the Certification Regime. As such, there are two related but distinct issues posed by the FCA's Discussion Paper – should the legal function, as a whole, be subject to the SMR, Certification Regime or conduct rules at all, and, if so, should the GC or head of legal be required to be approved as a Senior Manager.

The Law Society has concerns with the application of the SMR to in-house lawyers. In particular, they perceive risks that legal professional privilege will be eroded, that in-house lawyers will be put into a conflict of interest situation with their employer which will affect their ability to offer full and frank legal advice, and that in-house lawyers will be subjected to a double regulatory burden, since they are already overseen by the Solicitors Regulation Authority or the Bar Standards Board. These concerns are particularly acute when applied to the status of the GC as a Senior Manager.

But what is it about in-house lawyers that makes them different from other members of staff? It is easy to point out, contrary to the Law Society, that the double regulatory burden is equally applicable to other professionals, such as accountants and actuaries, and that the potential for conflicts of interest between employer and employee in the context of regulatory scrutiny is hardly a new phenomenon. Further, given that

section 413 of the Financial Services and Markets Act 2000 provides that no one can be compelled by the PRA or FCA to disclose 'protected items' (which includes legally privileged items) and that the FCA insists that the focus of the SMR is on the operational management of the legal function, rather than the content of legal advice, one might question what the fuss is about.

However, despite the FCA's argument that operational failings in the legal function, such as inadequate training and poor resource management, are distinct from the quality and accuracy of any specific legal advice, it is hard to see a bright line that cannot become blurred in practice. For example, at what point does an 'operational' concern regarding the quality of the lawyers employed by a firm (e.g. seniority, specialists versus generalists, ongoing training, number of staff etc.) become an assessment of the quality of advice they provide to the firm?

In addition, this is not the first time in recent years that legal professional privilege has been perceived to have been under threat by the UK's regulatory and enforcement bodies. In 2015, representatives of the FCA and the Serious Fraud Office gave notable speeches in which they vented their frustration with the use of legal privilege by firms to seek to protect aspects the results of internal investigations conducted by firms prior to formal enforcement processes by the regulators. In this context, whilst it is unlikely that the inclusion of the legal function in the SMR is directly attributable to any desire on the part of the FCA to 'weaponise' its frustrations, it is not implausible to imagine the pressure which could be felt by heads of legal from the PRA and the FCA.

It is not currently clear in what circumstances the regulators would seek to take action against a Senior Manager who was responsible for the legal function. For example, if legal advice was regarded as having led to a breach of a regulatory requirement, say, by the sales department, because of a contested interpretation of a rule or law where the FCA disagrees with the firm's interpretation, would this allow the FCA to accuse the legal function of itself being responsible for the breach of a regulatory requirement? Might this lead to legal function feeling constrained from "taking a view" in cases where the law is not clear?

The above concerns are not meant to be alarmist but are instead designed to encourage a discussion around the appropriateness of a system which could potentially result in lawyers having regard to self-interest as distinct from their client's interests. We suggest that any such system must be deployed very carefully. It is therefore welcome that the FCA is inviting discussion and consultation on this issue.

The FCA's difficulty is that the logic of the SMR does not currently recognise any difference between internally-facing functions and the functions one might more commonly regard as being 'business functions' and its structure does not easily allow for exemptions. The Law Society hasn't yet rehearsed in detail its arguments that legal professional privilege is threatened. Instead it simply asserts that there may be some circumstances in which a GC may, "*feel obliged to disclose legally privileged information*" and that this "*could impact on the advice given and on the ability to ensure a fair trial*". Given the FCA's "no gaps" approach to date, if lawyers believe that they should be treated differently from other business functions, these arguments will need to be coherently and persuasively developed and we would therefore encourage all GCs who are concerned with what the SMR means for them to engage with this process and help to develop the arguments on both sides.

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