

Discussion Paper

DP16/4

Overall responsibility and the legal function



September 2016

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We are asking for comments on this Discussion Paper by 9 January 2017.

You can send them to us using the form on our website at:
www.fca.org.uk/dp16-4-response-form

Alternatively, you can write to:

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Abbreviations used in this paper

CP	Consultation Paper
FCA	Financial Conduct Authority
FSMA	Financial Services and Markets Act
MRT	Material Risk Taker
PCBS	Parliamentary Commission on Banking Standards
PRA	Prudential Regulation Authority
SMR	Senior Managers Regime
SM&CR	Senior Managers and Certification Regime
SMF	Senior Management Function
SoR	Statement of Responsibility

1. Overview

Introduction

- 1.1** The new accountability regime for the banking sector, the Senior Managers and Certification Regime (SM&CR), came into force on 7 March 2016.
- 1.2** The rules aim to enhance and embed a culture of individual responsibility and accountability within firms. Clear individual responsibility and accountability should focus minds, drive up standards, and make firms easier to run and supervise. If things go wrong, the regime will allow Senior Managers to be held to account where they are at fault for misconduct that falls within their area of responsibility.
- 1.3** To ensure clear lines of accountability throughout a firm, one of the principles of the SM&CR is that a Senior Manager must have 'overall responsibility' for each area of the firm's business, ensuring complete coverage (i.e. there are 'no gaps'). This principle has been outlined in our key publications on the SM&CR since July 2014¹, in which we sought to ensure that relevant firms understood the new approach taken under the SM&CR to focus on individuals who hold key roles or have overall responsibility for business areas of the relevant firm.
- 1.4** We recognise that the new regime is a departure from the previous approach under the Approved Persons Regime and we have been working closely with firms in the implementation of the SM&CR.
- 1.5** As part of our engagement with industry, we have received feedback from firms questioning how 'Senior Management Function 18 – Other Overall Responsibilities' (SMF18) applies to the legal function. Currently, a Senior Manager must have overall responsibility for all areas of the firm (including the management of the legal function) and this may mean appointing the head of the function as an SMF18 if they are not already captured as another Senior Manager (for example, as the Head of Compliance). Many firms felt that it had not been clear that a Senior Manager must be appointed for overall responsibility of the legal function, while others considered it inappropriate for the Senior Managers Regime (SMR) to apply to the legal function at all. Further, firms were concerned that our regime requires the General Counsel or Legal Director to be captured as a Senior Manager in their role in providing legal advice to the firm.
- 1.6** We published a statement on our website² in January this year that recognised the concerns raised by the legal profession. We clarified that, although the legal function was included in the regime, any firm that had made a decision in good faith on the basis of the published rules

¹ See CP14/13 Strengthening accountability in banking: a new regulatory framework for individuals (July 2014); CP15/9 Strengthening accountability in banking: a new regulatory framework for individuals (March 2015); and CP15/22 Strengthening accountability in banking: Final rules (July 2015).

² www.fca.org.uk/news/supervisory-intentions-overall-responsibility-legal-function-under-senior-managers-regime.

and our other communications about whether or not the person in charge of the legal function needed to be approved, would not need to change their approach in the interim.

- 1.7** The purpose of this Discussion Paper is to clarify how and why the legal function is currently captured under the SMR, and to consider whether the legal function should continue to be part of the SMR going forwards.

Who does this document affect?

- 1.8** This paper will primarily be of interest to UK banks, building societies, credit unions and PRA-designated investment firms (collectively referred to in this paper as 'relevant firms'). It will also be of interest to incoming branches of overseas relevant firms as well as other groups – particularly legal professional bodies. It may also be of interest to other FSMA-authorized firms that the SM&CR will be extended to.

Is this of interest to consumers?

- 1.9** This paper will primarily be of interest to firms. Consumers may be interested in how the SM&CR operates within relevant firms to enhance individual accountability.

Context

- 1.10** The Financial Services (Banking Reform) Act 2013 created the legislative framework that underpins the SM&CR. This followed the publication of recommendations by the Parliamentary Commission on Banking Standards (PCBS), which was appointed to consider and report on professional standards and culture of the UK banking sector in the wake of the financial crisis. PCBS found problems in areas such as benchmark setting, corporate governance, transparency, and conflicts of interest.
- 1.11** Our final rules for the SM&CR came into force on 7 March 2016, as set out in CP15/22 Strengthening accountability in banking. The SM&CR is designed to ensure that Senior Managers can be held to account for any misconduct that falls within their areas of responsibility, and to hold individuals working at all levels in relevant firms to appropriate standards of conduct.
- 1.12** At a senior level, this is achieved by ensuring that the right people are in the right roles. The regulators pre-approve any individual who holds a defined Senior Manager role; setting out a list of prescribed responsibilities that firms must allocate to Senior Managers; and requiring firms to ensure that there is always a Senior Manager who has overall responsibility for each of the firm's activities, business areas and management functions.
- 1.13** Firms are also required to produce Statements of Responsibility (SoR), clearly listing all areas for which a Senior Manager is responsible. Firms must also produce management responsibility maps to show how all responsibilities are allocated across the firm. A key purpose of these maps is to ensure that, when looked at collectively, all areas and responsibilities are allocated to a Senior Manager with no gaps.

- 1.14** As part of implementing the new regime, firms said they had some uncertainties regarding the application of the SMR to a firm's legal function. Firms told us that they are concerned that the inclusion of the legal function within the SMR could lead to adverse implications for culture within relevant firms and for the in-house legal profession. Specifically, the worry is that it would compromise the independence of the legal function and their ability to offer legally privileged and impartial advice.
- 1.15** On 27 January 2016, we published a statement on our website³ to acknowledge the concerns raised by the legal profession and to indicate our plans to consult further on including individuals with overall responsibility for the legal function within the SM&CR. In our statement, we clarified that although the legal function is not included in our indicative list of business activities and functions, responsibility for the management of the legal function should be included in the regime. Therefore, firms would need to identify the role as an SMF18 when allocating senior management responsibilities if it was not covered by another specific SMF in the firm.
- 1.16** However, we recognise the confusion in this area and acknowledge that our previous communications were not sufficiently clear. It was for these reasons that our January statement confirmed that any firm that sought to make a decision in good faith about whether or not an individual in charge of their legal function required approval, on the basis of the published rules and our other communications, should not need to change their approach in the interim.
- 1.17** Since the publication of our statement, we have actively engaged with the legal profession to better understand their concerns about applying the SM&CR to the management of the legal function.
- 1.18** We wish to balance the independence of the legal function and its ability to offer legally privileged and impartial advice with the principles and expectations of the SMR.
- 1.19** Accordingly, this Discussion Paper seeks to clarify our approach and policy rationale behind SMF18 and its current application to the legal function. We invite feedback from stakeholders on our policy analysis of the arguments both in favour and against maintaining our current position. Ultimately, we invite views on whether the legal function should continue to be included within the SMR going forwards.

Next steps

- 1.20** We welcome submissions on the questions posed in Chapter 4 of this discussion paper by **9 January 2017**. Please send your submissions using the online response form on our website or by emailing dp16-4@fca.org.uk. Alternatively, you can write to us at:

Governance and Professionalism Policy
Strategy & Competition Division
Financial Conduct Authority
25 North Colonnade
Canary Wharf
London E14 5HS

³ www.fca.org.uk/news/supervisory-intentions-overall-responsibility-legal-function-under-senior-managers-regime.

- 1.21** After the consultation period has closed, we will analyse responses and provide feedback, clarifying what is required in this area. Should we need to take forward any further policy proposals, we will issue a Consultation Paper in due course.

2. Background on the SMR and the legal function

Introduction

- 2.1** This chapter gives some background on the purpose of the SMR. In particular, it explains the policy rationale behind allocating ‘overall responsibility’ to a Senior Manager for every area of the firm’s business, including the legal function. The following chapter explores whether we should continue to apply the SMR to the legal function.

The purpose of the SM&CR

- 2.2** The SM&CR is a new accountability framework, which was put in place following a review by the PCBS on professional standards and culture in the UK banking sector. The PCBS recognised that improving standards within relevant firms is important in order to restore trust in financial services. As such, they recommended a series of measures to increase individual accountability.
- 2.3** A core principle of the SM&CR for relevant firms is to ensure that every part of a firm’s business or activities has a Senior Manager with overall responsibility for it.⁴ This Senior Manager must be pre-approved by the regulators, will be subject to the Senior Manager Conduct Rules and will have a duty of responsibility (rather than a ‘presumption of responsibility’⁵) for the management of their function. The PCBS was concerned that gaps in accountability meant issues could ‘fall between the cracks’ and noted that this was one of the challenges that regulators have faced in holding individuals to account for failures within firms. This ‘no-gaps’ approach was a deliberate departure from the previous Approved Persons Regime.
- 2.4** In order to allocate responsibilities clearly, we took the following three-fold approach to identifying and allocating responsibilities to Senior Managers under the SM&CR:
- **SMFs:** There are 17 SMFs under the Financial Conduct Authority’s (FCA) and the Prudential Regulation Authority’s (PRA) rules, with the FCA-specified SMFs set out in the FCA Handbook SUP10C.4 to SUP10C.8. Firms must ensure that any individual who holds one of these functions (for example, the Chief Executive Officer) is pre-approved by the regulators.
 - **Prescribed responsibilities:** There are then a set of 30 Prescribed Responsibilities under the FCA and PRA’s rules, which firms must assign to individuals who hold SMFs.

⁴ SYSC 4.7.8R provides that ‘A firm must ensure that, at all times, one or more of its SMF managers have overall responsibility for each of the activities, business areas and management functions of the firm’. An equivalent rule for non-EEA branches is in SYSC 4.8.10R.

⁵ The presumption of responsibility was proposed to apply to Senior Managers so that, to avoid being found guilty of misconduct when there has been a regulatory contravention in an area for which they were responsible, they would have to prove that they took reasonable steps to prevent that contravention. This presumption of responsibility was removed by the Bank of England and Financial Services Act 2016 and has been replaced by a ‘duty of responsibility’, which the regulators have the burden of proving.

- **Other individuals with 'Overall Responsibilities':** Finally, firms must look across their business and ensure that each of the firm's activities, business areas and management functions has a Senior Manager with overall responsibility for it. This Senior Manager must also be pre-approved by the regulators, which can be done one of two ways:
 - **Existing SMF:** If the Senior Manager with overall responsibility for an area holds a specified SMF⁶, then they will already have been pre-approved as in the first step above. It is our expectation that individuals performing governing or required functions will, between them, hold overall responsibility for the majority of a firm's activities, business areas and management functions.
 - **SMF18:** If they do not hold any specific SMF, they will need to be pre-approved as an SMF18 – Other Overall Responsibility function.⁷
- 2.5** Additionally, the Financial Services and Markets Act 2000 (FSMA) requires firms to produce SoRs for Senior Managers, while the FCA's and PRA's rules require firms to produce management responsibilities maps, setting out overall governance for the firm. The SoR clearly lists all areas for which a Senior Manager is responsible. This implements the PCBS recommendation to ensure that 'the key responsibilities within banks are assigned to specific individuals who are aware of these responsibilities and have formally accepted them'.
- 2.6** Management responsibilities maps show how responsibilities are allocated across the firm. A clear, comprehensive management responsibilities map supports evidence that a firm is satisfying its obligation to have robust governance arrangements. These arrangements include a clear organisational structure with well-defined, transparent and consistent lines of responsibility (as set out in SYSC 4.1.1R and the 'Allocation of Responsibilities Part of the PRA Rulebook (7 – Records)').
- 2.7** Firms need to make sure that they understand and carefully consider the concepts of SMFs, Prescribed Responsibilities and Overall Responsibility, and how these apply to their business. It is important for firms to make sure that they have a clear understanding of the allocation of responsibilities between senior individuals so that, overall, the right people are held accountable. We expect responsibilities to be allocated to individuals who are senior enough and have sufficient authority and resources to discharge their roles appropriately.

The concept of SMF18 – Other Overall Responsibility

Purpose of SMF18

- 2.8** The purpose of the Other Overall Responsibility Function (SMF18 – in the case of a UK firm) and the Other Local Responsibility Function (SMF22 – in the case of a non-EEA incoming branch) is to allow a firm to allocate overall responsibility for an activity, business area or management function to someone whose job is not otherwise included in the list of SMFs. It facilitates the function under SYSC 4.7.8R (and the equivalent provision for non-EEA incoming branches) being carried out by a pre-approved Senior Manager without unduly constraining the ability of firms to organise their Senior Manager arrangements, as appropriate, and allocate responsibilities to the most suitable people.

⁶ As set out in SUP10C.4 to SUP10C.8 and the corresponding PRA rules.

⁷ SYSC 10C.4.3R designates 'SMF 18 – Other overall responsibility function' as an FCA-designated SMF. As set out in SYSC 10C.10, any individual who performs an FCA-designated SMF must have prior approval from the FCA.

2.9 We believe SMF18 and SMF22 are important as they give firms flexibility to adapt the function for specific business structures and governance arrangements. There is no automatic requirement for a firm to designate someone under SMF18 or SMF22. Instead, SMF18 and SMF22 are designed to avoid forcing firms to allocate overall responsibility to individuals who are not, in practice, accountable for these areas of the business, but who happen to already be approved for other reasons. This means that firms can allocate overall responsibility to the most appropriate Senior Manager, recognising that this may sometimes be an individual who is not already performing a governing or required SMF, depending on how a firm is organised. In other words, we want to know who the most senior person with responsibility is for a particular area, activity or function in day-to-day practice.

2.10 We expect that, in many cases, overall responsibility will be allocated to individuals who are already approved for one of the other FCA or PRA SMFs. Accordingly, firms should only use SMF18 or SMF22 when needed.

Handbook provisions

2.11 We recognise that the requirements and guidance regarding SMF18 appear in different sections of our Handbook. To this end, firms may find it helpful to refer to the rules below to understand how different rules and guidance interact:

2.12

Handbook reference	Provision
SYSC 4.7.8 R	A firm must ensure that, at all times, one or more of its SMF managers have overall responsibility for each of the activities, business areas and management functions of the firm.
SYSC 4.7.9 G	The purpose of SYSC 4.7.8R (Allocation of overall responsibility for a firm's activities, business areas and management functions) is to avoid gaps. It is to make sure that an SMF manager has responsibility for every part of a firm's activities, business areas and management functions not otherwise covered by other parts of this section or by the equivalent PRA requirements.
SYSC 4.7.36 G	Having overall responsibility for an activity under SYSC 4.7.8R requires approval as an SMF manager. This is because a person who has overall responsibility for an activity will be: <ul style="list-style-type: none"> • performing the other overall responsibility function; or • approved to perform another designated SMF
SYSC 10C.4.3 R	This rule sets out the list of FCA-designated SMFs that require pre-approval under our rules. This includes SMF18.
SYSC 4 Annex 1 G	This Annex sets out the main business activities and functions of a relevant firm to help firms in preparing their management responsibilities maps. However, as noted in SYSC 4.5.16 G (4), SYSC 4.5.20 G (1) and SYSC 4.7.37 G (4), this list is not comprehensive.
SYSC 4.8.10 R	This rule sets out the equivalent rule for third-country branches as those for UK firms outlined above. For the purposes of this paper, the rules for third country branches are the same as the rules for UK firms and will therefore not be explicitly referred to again.

The SMR and the legal function

- 2.13** The relevant legislative and regulatory framework does not contain any requirement that the role of the General Counsel be designated a Senior Manager within the SMR. However, as outlined above, our current rules require that a Senior Manager must have overall responsibility for every activity, business area or management function in a relevant firm. This includes the legal function. As such, whoever has overall responsibility for management of the legal function needs to be captured as an SMF18 if they are not already captured under another SMF (such as the Head of Compliance). Since publication of our final rules, we have received considerable feedback from firms about the responsibility for a firm's legal function within the SMR. Many firms felt that it was not clear that a Senior Manager must be appointed for overall responsibility of the legal function, while others considered it inappropriate for the SMR to apply to the legal function at all. Firms were also concerned that our regime requires the General Counsel or Legal Director to be captured as a Senior Manager in their role of providing legal advice to the firm.
- 2.14** As we did not receive this feedback prior to publication of the final rules, it is difficult to assess the impact that this information would have had on our policy-making process. However, given the feedback is both substantive and consistent across many stakeholders, we agree that it would have likely affected our policy-making. We also acknowledge that firms' confusion has been exacerbated by inconsistent FCA communications on the subject.
- 2.15** As a point of clarification, the feedback that we received was limited to the designation of the head of the legal function as a Senior Manager, and not in relation to the application of the SM&CR to lawyers more broadly. In particular, we note that all employees within the legal function (except for ancillary staff, such as personal assistants) are subject to the Conduct Rules. The Certification Regime also captures all 'Material Risk Takers' as defined under the remuneration rules of CRD IV, which specifically includes the head of the function responsible for legal affairs.⁸ As such, the head of the function responsible for legal affairs will be caught under the Certification Regime, even if they are not designated a Senior Manager.
- 2.16** The current FCA rules also capture a lawyer if they hold another SMF, regardless of their professional background or training. The FCA's specified SMFs are set out in SUP10C.4 to SUP10C.8. Before an individual performs one of these specified functions, or those specified by PRA in its Rulebook, they will need to seek pre-approval. This was also the case under the old Approved Persons regime, and remains the case for those FCA firms to which the Approved Persons regime continues to apply.

⁸ Article 3 (9) of Commission Delegated Regulation (EU) No 604/2014.

3.

The head of the legal function as an SMF

Introduction

- 3.1** In Chapter 2, we outlined the spirit and principles behind SMF18 and its application to the legal function. In this chapter, we explore the relative benefits and risks of including this function within the regime on an ongoing basis.
- 3.2** We seek an open debate on how the SMR should apply to the management of legal function and invite feedback from stakeholders on our policy analysis of the arguments in favour and against maintaining our current position, as well as views on whether SMF18 should continue to apply to the management of the legal function. In line with this approach, this chapter sets out the arguments for and against including the head of the legal function in the SMR but does not reach any conclusions on these arguments.

Reasons to exclude the head of the legal function from the SMR

- The legal function is not an ‘activity, business area or management function’**
- 3.3** The FCA Handbook rule SYSC 4.7.8R states that a firm must ensure that, at all times, one or more of its SMF managers have overall responsibilities for each of the activities, business areas and management functions of the firm.
- 3.4** However, as the management of the legal function is often not recognised by stakeholders as a ‘business area’, ‘activity’ or ‘management function’ of a firm as defined in this rule, some have argued that this rule does not apply to the legal function. As the primary role of an internal legal function is to provide independent advice to the business, this could be viewed as separate to an activity, business area or management function.
- The legal function is an advisory function**
- 3.5** The role of the head of the legal function is fundamentally an advisory one and not one that involves ‘management’ of the authorised person’s affairs. The result is that the legal function cannot be designated as an SMF under section 59ZA of the FSMA. This is supported by referencing the November 2013 debate in the House of Lords over the inclusion of relevant firms’ legal functions in the SMR, citing Lord Newby who stated that ‘it is... highly unlikely that the regulators would designate being a legal adviser as an SMF because giving advice does not constitute management as set out in the definition of senior management’.
- Flexibility to allocate ‘overall responsibility’**
- 3.6** Although there is no specific requirement for a General Counsel to be designated an SMF and firms have flexibility to determine who to allocate overall responsibility for the legal function to, in practice many firms will feel that the General Counsel is best placed to take overall responsibility for this function. This will mean that the General Counsel is subject to the SMR,

which may in turn impact on the General Counsel's and the legal function's ability to provide impartial and independent advice to the business, which we explore in greater detail below.

Legal professional privilege

- 3.7** The principle of legal professional privilege protects the confidentiality of communications between client and lawyer, by prohibiting a lawyer from revealing either information provided to them in confidence, or advice they have provided, without the client's permission.
- 3.8** There is concern that the inclusion of the head of the legal function in the SMR will prejudice legal privilege. In particular, under the duty of responsibility described in Chapter 2, disciplinary action may be taken against a Senior Manager where there has been a contravention of a regulatory requirement in an area of the firm that the Senior Manager is responsible. Some argue that in practice, the only way that a Senior Manager can defend such a case is to demonstrate that they took 'reasonable steps'. In turn, that may mean that they need to rely on privileged material in order to demonstrate such steps in a meaningful way. For example, as the core activity of the legal function is to provide legal and regulatory advice, the legal function may be challenged as to the 'reasonable steps' it took in providing such advice, which could involve scrutiny of the quality of the advice that they provided. This may mean that a firm is put under pressure to waive the privilege.
- 3.9** From the individual's perspective, there is a concern that defending a case based on the duty of responsibility is particularly difficult, as the privilege in the legal advice is the firm's (not the individual's) to waive, which means that the ability of the head of the legal function to demonstrate such 'reasonable steps' may depend on the firm's willingness to waive privilege. Even if the focus of the SMR as it applies to the head of the legal function is on their role as a manager and not on giving legal advice, it is argued that it is difficult to separate the two.
- 3.10** Finally, Rule 4 of the Senior Manager Conduct Rules requires a Senior Manager to disclose any information of which the FCA or PRA would reasonably expect notice, which could be seen to cut across the principle of legal professional privilege. Firms view this as a more proactive duty to disclose information to the regulators than Conduct Rule 3 (which applies to all staff), requiring individuals to be open and cooperative with the FCA, the PRA and other regulators.

Independence of the legal function

- 3.11** The threat to legal professional privilege has the potential to compromise the independence (or perceived independence) of the advice provided by the legal function and alter how a firm subsequently engages with a General Counsel and the legal function.
- 3.12** This is on the basis that requiring the legal function to be headed by a Senior Manager will mean that the advice that the legal function provides could be disclosed and scrutinised by regulators (if a firm chooses to waive legal privilege). In turn, this could mean that personnel in the legal function are incentivised to protect their own interests rather than provide impartial and independent advice.
- 3.13** Independence could also be compromised if the regulator brought enforcement action against a head of the legal function, as they could face a personal conflict of interest between protecting their own personal position under the SMR and the duty to act in the best interests of their client. This would include protecting legal advice. Similarly, if the head of the legal function were asked to advise Senior Managers in relation to their SMF responsibilities or a potential breach of the Conduct Rules, they could be conflicted between their own personal accountability to the regulator for this advice and their professional regulatory obligations to the firm.

3.14 It could also be argued that one feature of the SMR is that we will focus more of our supervisory resources on Senior Managers as compared to the old Approved Persons regime. This could mean that treating the head of the legal function as a Senior Manager will increase the risk that their independence will appear to be reduced.

3.15 The perception of the legal function is important. A person is more likely to seek and follow advice if they believe that the advice is not subject to external influence. The argument is that the factors that tend to undermine independence outlined above will lead the firm's personnel to doubt the independence of the legal function, even if independence is not compromised in reality.

Overlap with other regulations

3.16 If the head of the legal function is a lawyer, then they will also be regulated by the Solicitors Regulation Authority (SRA) or Bar Standards Board (or equivalent body in Scotland, Northern Ireland or overseas). These bodies have their own regulatory regimes that impose ethical and conduct obligations on lawyers. As such, there is potential for overlapping or conflicting regulation with the relevant legal sector regulators.

Insufficient benefits

3.17 Including the head of the legal function in the Certification Regime and applying Conduct Rules delivers most of the benefits of including them within the SMR without compromising their independence. As so much of the head of the legal function's work relates to legal advice, the laws of legal privilege may restrict in practice the regulators from using their powers over Senior Managers. According to this argument, the benefits that normally result from applying the SMR will be substantially reduced.

Additional issues

3.18 Some of the difficulties explained above arguably apply whether or not the head of the legal function is included in the SMR. This is because it could be argued that the difficulties come from the application of the Conduct Rules rather than the application of the SMR. However, being included in the SMR gives rise to additional responsibilities. The principal consequences of being captured as a Senior Manager are:

- pre-approval by the regulator of a Senior Manager's appointment
- compliance with the Senior Manager Conduct Rules, in addition to the Conduct Rules more broadly, and
- a duty of responsibility under the FSMA, which means Senior Managers are required to take steps that are reasonable for a person in their position to take in order to prevent a regulatory breach from occurring.

3.19 As shown in the previous paragraphs, all these aspects of the SMR could give rise to reasons why the head of the legal function should be excluded from the SMR.

Reasons to keep the head of the legal function in the SMR

The legal function is an 'activity, business area or management function'

3.20 In the FCA's view, the words 'activity, business area or management function' in FCA Handbook rule SYSC 4.7.8R covers everything that a firm does, including internally-facing functions, such as legal. For example, the non-exhaustive list of activities, business areas and management

functions included within CP15/22 include a broad range of both internal and external facing activities, business areas and management functions, such as Human Resources and information technology.

- 3.21** The FCA agrees that management in section 59ZA of FSMA does not cover giving legal advice. However, it is the management of the function and not the provision of legal advice that brings the head of the legal function into the SMR. There is a requirement for a firm to assign overall responsibility for every aspect of its business, including the legal function, to a Senior Manager. Having overall responsibility for the legal function is likely to come within section 59ZA, as it will involve management of that function. There is no specific requirement for a General Counsel to be designated a Senior Manager (this is discussed further in paragraph 3.33).

Failings in the legal function can impact the wider business

- 3.22** We implemented SYSC 4.7.8R and SMF18 to help achieve the 'no-gaps' principle in our rules. The PCBS felt that without complete coverage of a firm at the senior level, key responsibilities or accountabilities within it could remain unallocated which risked undermining the regime in the event of failings of a relevant firm. We agree with this finding.

- 3.23** Systemic failings in the management of the legal function, as well as in other internal functions, such as Human Resources or Marketing, could create risks that can in turn impact the wider business and result in a failing within the firm. These risks stem from the management of the function, such as inadequate training, weak processes or poor resource management. These concerns are distinct from the quality and accuracy of any specific legal advice provided by the function, which we are not seeking to regulate.

Operational management of the function

- 3.24** The focus of the SMR is not on the provision of legal advice but on the effective management of the function. For example, this includes the requirements of the Senior Manager to take reasonable steps to ensure the business of the firm is controlled effectively, that the business complies with regulatory requirements and that any delegation of responsibilities is appropriate and properly overseen. These requirements are relevant and appropriate for all Senior Managers regardless of their role, qualifications, training or business area.

- 3.25** As the focus and purpose of the SM&CR is on the responsibility for managing the function (rather than the advice that they provide), there is an argument that privileged material would not need to be disclosed in order to demonstrate reasonable steps in managing the function. This means that the FCA does not need to have access to legally privileged material to include the head of the legal function in the SMR. As the types of issues described above give rise to a sufficiently wide and important range of matters, they do not require the FCA to have access to legally privileged material to justify inclusion of the function within the SMR, and we can effectively supervise the function without access to legally privileged material.

- 3.26** Similarly, pre-approval of a Senior Manager responsible for the legal function is effective without prejudicing legal privilege.

Privilege and the duty of responsibility

- 3.27** It is possible that the concerns around legal privilege arose as a response to the presumption, rather than the duty, of responsibility. The presumption of responsibility (which has been replaced by the duty) placed the burden on the Senior Manager to show that they had taken such steps as a person in their position could reasonably be expected to take to stop the firm's contravention of a relevant requirement occurring. However, the duty of responsibility places the burden on the regulators to prove whether or not reasonable steps have been taken – not the Senior Manager. Typically, it would be extremely difficult for us to bring a successful action

for a breach of the duty of responsibility solely in reliance on privileged material, if the firm has chosen not to waive privilege over it. The position would be no different if the enforcement action were brought under the Conduct Rules.

Privilege and independence

- 3.28** There are some additional arguments in favour of the view that inclusion of the head of the legal function in the SMR does not prejudice legal privilege.
- 3.29** Section 413 of the FSMA protects legal privilege by providing that no power under the Act can be used by the FCA to require the disclosure of 'protected items'. These are defined in terms that are materially identical to the definition of items subject to legal professional privilege in Section 10 of the Police and Criminal Evidence Act 1984. Recognising these protections, the application of the SMR does not and cannot remove legal privilege.
- 3.30** It can be argued that these protections against breaches of legal privilege will also counter the perception that the independence of the legal function is compromised by the inclusion of the head of the legal function in the SMR.
- 3.31** In relation to the Conduct Rules, COCON 4.1.12G of the FCA Handbook recognises that the right to preserve legal professional privilege may be a good reason not to cooperate with a regulator's request for information, with reference to Rule 3 of the FCA's individual Conduct Rules. We welcome feedback on whether it would provide greater certainty to firms if we added a clarification to Rule 4 of the Senior Manager Conduct Rules to reflect the guidance in COCON 4.1.12G on the interaction between the SMR and legally privileged information.
- 3.32** A final argument on legal privilege is that any threat to legal privilege caused by the need to rely on privileged legal advice is equally applicable to a non-legal Senior Manager who has received legal advice and wishes to show that they took all reasonable steps to avoid regulatory breaches. This means that the argument of privilege is not specific to the head of the legal function, and so does not justify special treatment under the SMR for the head of the legal function.

Flexibility to allocate 'overall responsibility'

- 3.33** The relevant legislative and regulatory framework does not contain any requirement that the role of the General Counsel be designated a Senior Manager within the SMR. Instead, it requires that whoever has overall responsibility for management of the legal function be captured as an SMF18, if they are not already captured under another management function.
- 3.34** As the SMR does not mandate who should be allocated overall responsibility for the legal function, firms have the flexibility to designate the most suitable person to have overall responsibility. For example, the Chief Executive Officer or another Director may have overall responsibility for the legal function; or the legal function may be embedded in another department (e.g. Compliance or Human Resources). In this case, the SMF with overall responsibility for those departments may also be given overall responsibility for the management of the legal function.

No conflict with other regulation

- 3.35** When considering the relevant rules and principles that cut across the financial and legal professions, there is an argument that the approaches taken by the FCA and the counterpart regulators for the legal profession are consistent. Annex 1 of this paper compares the Conduct Rules under the SMR with the SRA principles. The FCA has a clear mandate to protect consumers, enhance market integrity and promote competition in the interest of consumers. In regulating the SM&CR, we seek to ensure that the individuals performing SMFs within relevant firms are

fit and proper for their role as a Senior Manager, and properly oversee the management of the relevant function.

- 3.36** There are also professionals who are already subject both to the SMR and regulation by another professional body, and these relationships work well and any overlap between the SMR and the regulators for the legal professions should not create any difficulties. The FCA's mandate is derived from the FSMA and differs from that of other regulators. We already work closely with counterpart regulators for professionals, such as those for accountants and actuaries, and for members of the legal profession who are already subject to regulation as part of the Approved Persons regime. This includes working to avoid duplication, sharing relevant information, and enabling each party to discharge their respective functions. We will continue to work closely with them in the future, and these working arrangements will cover heads of firms' legal functions if they are included in the SMR.

4. Next steps

- 4.1 We recognise the concerns of the legal profession about the inclusion of the legal function within the SMR and are conscious of the potential challenge to legal professional privilege, confidentiality and independence of advice that the designation of a Senior Manager in charge of the legal function may cause.
- 4.2 We invite feedback from stakeholders on our policy analysis of the arguments for and against maintaining our current position, as well as views on whether the legal function should be included within the SMR going forward.

List of questions

- 4.3 We invite you to answer the following questions:
 - Q1: 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?**
 - Q2: 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?**

Annex 1

Comparison of the FCA Conduct Rules with the SRA Principles

FCA Individual Conduct Rules ⁹		SRA Principles ¹⁰	
		You must:	
Rule 1:	You must act with integrity.	1.	uphold the rule of law and the proper administration of justice;
Rule 2:	You must act with due skill, care and diligence.	2.	act with integrity;
Rule 3:	You must be open and cooperative with the <i>FCA</i> , the <i>PRA</i> and other regulators.	3.	not allow your independence to be compromised.
Rule 4:	You must pay due regard to the interests of <i>customers</i> and treat them fairly.	4.	act in the best interests of each <i>client</i> ;
Rule 5:	You must observe proper standards of market conduct.	5.	provide a proper standard of service to your <i>clients</i> ;
FCA Senior Manager Conduct Rules¹¹		6.	behave in a way that maintains the trust the public places in you and in the provision of legal services;
SC1:	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.	7.	comply with your legal and regulatory obligations and deal with your regulators and ombudsmen in an open, timely and co-operative manner;
SC2:	You must take reasonable steps to ensure that the business of the <i>firm</i> for which you are responsible complies with the relevant requirements and standards of the <i>regulatory system</i> .	8.	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;
SC3:	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.	9.	run your business or carry out your role in the business in a way that encourages equality of opportunity and respect for diversity; and
SC4:	You must disclose appropriately any information of which the <i>FCA</i> or <i>PRA</i> would reasonably expect notice.	10.	protect <i>client</i> money and <i>assets</i> .

9 SYSC 2.1 Individual Conduct Rules.

10 www.sra.org.uk/solicitors/handbook/code/content.page.

11 SYSC 2.2 Senior Manager Conduct Rules.

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