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Herbert Smith Freehills and London School of Economics Regulatory Reform Forum

Legal risks and risks for lawyers

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London School of Economics

June 2013

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The financial crisis exposed risks that were not foreseen and in the subsequent quest to attribute blame to the financial institutions, their managers, auditors, regulators, credit rating agencies, and politicians, a question was also asked: where were the lawyers? Were lawyers close enough to the events that they should be blamed, whether for their actions, or for a failure to act as gatekeepers?

Herbert Smith Freehills and London School of Economics Regulatory Reform Forum held a roundtable discussion “Legal risks and risks for lawyers” to debate legal risks in financial institutions. The event was attended by senior members of the financial services industry, academics and lawyers. This paper summarises some of the issues debated, including:

- Practical challenges in identifying, assessing and monitoring legal risks
- Expectations on the role of lawyers in financial institutions
- Consequential liability for lawyers

We also report on a survey conducted of the firms invited to the forum, on the involvement of the legal function in legal risk management.

The discussion was subject to the Chatham House Rule; therefore none of the comments have been attributed to the participants. The views expressed in this paper do not represent the views of the forum as a whole.



IDENTIFICATION

ASSESSMENT

MONITORING

REPORTING

Identifying legal risks

A successful legal risk culture is one which provides a framework for legal risks to be identified, assessed, managed and monitored consistently at all levels in a financial institution. The key starting point is having an agreed definition of legal risk in place and, vitally, it being sufficiently understood and consistently applied across the organisation. Some may question whether a definition is required, however without it, the process of identifying risks and the triggers would be haphazard.

There is no standard definition of legal risk. The International Bar Association offers a definition, as being a risk of loss to an institution that is primarily caused by:

1. a defective transaction;
2. a claim (including a defence to a claim or counterclaim) being made or some other event occurring that results in a liability for the institution or other loss (for example as a result of the termination of the contract);
3. failing to take appropriate measures to protect assets (for example intellectual property) owned by the institution;
4. a change in law.

Other risks include regulatory risks (e.g. enforcement action resulting in fines), and professional liability risks (i.e. lawyers acting contrary to their professional obligations). Identifying every risk which falls within the definition would be inefficient and possibly impossible. Triggers assist in identifying those risks which firms are (or should be) particularly concerned about. Typically these will be:

- **Financial thresholds** – such as the amount of a claim (aggregation of multiple claims is important, as recent mis-selling issues have shown) and cost of remedy, as may be gleaned from past business reviews. Some risks may of course be difficult to quantify, for example the risk and associated costs of any regulatory sanction for non-compliance.
- **Reputational risk** – whether an issue would threaten the good reputation of the institution. Measuring this type of risk is inherently difficult.

Legal risk management systems must also be capable of identifying risks that have not yet crystallised. Risks may be 'invisible' for a number of reasons. Legal risk may derive from legal uncertainty, or from a court interpretation of the law which is contrary to the accepted understanding of the market. Alternatively they may be 'invisible' in the operational sense – the control functions of the firm, including the legal department, are not aware that individuals or divisions within the organisation are not complying with legal or regulatory standards (mis-selling, Libor submissions). Dedicating sufficient time to addressing 'invisible' risks, and making provision for these, is equally as important as tackling known and visible risks – although the temptation to focus on the latter is understandable.

Legal risk management, as with any risk management, also has to be forward looking, notwithstanding the intrinsic difficulties in achieving this. Knowledge of the present law is not sufficient, and given the pace of legal and regulatory change, firms are increasingly looking for efficient and effective ways of scanning the legal and regulatory horizon.

A successful legal risk framework will define the scope and parameters of legal risk, for example whether litigation risk includes threatened or potential claims, or whether employment claims and complaints to the Financial Ombudsman Service are within scope. When looking at changes to law and regulation, firms must decide whether risks should be confined to jurisdictions that it operates in, or encompass risks in any jurisdictions which may have an impact on the firm's financial position or its reputation.

Assessing, monitoring and reporting

Once legal risks are identified, the next stage is to assess those risks.

In order for the likelihood of risks and their impact to be assessed, assessors should have appropriate training, not only to ensure knowledge of the relevant law, but also to ensure sufficient acquaintance with the business. This is discussed further below. Lawyers should be prepared to articulate issues quantitatively as this will help to demonstrate value and enrich engagement with the business – something lawyers may not have excelled in doing traditionally or indeed often have shied away from.

It is also important that legal risks are assessed on a holistic basis, even if they are being reported on a business unit basis. Assessors should take stock of trends, and apply lessons learnt across the firm. Legal risk committees could serve to consolidate issues across the board, and to determine the scope of legal risks which need to be managed. A key question to be addressed is the threshold for assessment: what are risks being assessed against? What is the firm's 'legal risk appetite'?

Assessment of legal risks has to be accompanied by systems for their effective management. Responsibility should be assigned for assessing and managing aggregated issues across a firm. Legal risk policies for assessment must strike an appropriate balance between prescription and high level principles. If there is too much prescription, assessors risk focusing on 'ticking the boxes', rather than standing back and looking at what is intended to be achieved. An overly prescriptive policy may also create blind spots or gaps for risks to fall into, even if there are sophisticated risk management processes in place.

Another danger is that a narrow assessment methodology may tempt the business to circumvent legal consultation.

The nature of the firm may lend itself to either a prescriptive or principles based approach, and larger firms may decide that the former would be more successful. Either way, there must be clarity around procedures, processes and responsibilities. This does not necessarily mean legal risk management should be cloaked in bureaucracy.

Once risks are assessed, what should be reported and to whom? Typically firms' legal risk policies will specify the regulatory reporting cycle, however there needs to be a mechanism for escalating and reporting urgent issues if they arise outside of the cycle. It needs to be clear who has that responsibility and who are they reporting to.

Responsibility also needs to be allocated for mitigating the risks identified and reported and appropriate feedback loops should be in place.

Role of lawyers in financial institutions

The traditional role of the legal function has been as protector of the firm and its assets, providing technical advice and recommendations on a wide range of legal and compliance issues. In a sense, this could arguably have been considered an ad-hoc and somewhat reactive role, being an 'identifier' of legal risks, but not substituting decisions for those of senior management or line supervisors.

However, some firms are encouraging their lawyers to take on a more proactive role, advising on the suitability and appropriateness of particular transactions and commercial strategy, on the basis that reputational damage can attach to transactions even if they are legally compliant (eg, tax planning). Lawyers may be expected to make assessments and advise on highly nuanced issues such as: 'what might be perceived to be aggressive?' or 'what is the right balance between shareholder return and commercial interests?' A move away from the traditional legal role to that of a 'trusted adviser' may require a change in views of senior staff. There may also be a tension between the competing interests of commercial and legal judgement.

Integration of the legal function within wider risk management systems

Legal risks cut across many other forms of risk and need to be integrated into wider risk management systems. There is a tension between legal risk management and general risk management, resulting from difficulties in reconciling the categorisation of commercial risks tailored to particular businesses and their bespoke processes, with the more sweeping scope of legal risk. Integrating the management of legal risks within the wider risk management framework may also create difficulties in preserving legal privilege, since it could lead to the circulation and escalation of information that would otherwise be privileged beyond the legal teams and into wider risk management systems.

Nevertheless, there are significant benefits to facilitating closer integration of the legal function with the firm's governance risk and compliance management capabilities. In pure governance terms, the origination and management of legal risk remains the primary responsibility of the business. In terms of the three lines of defence, legal can play a role in legal risk management in (at least) the first two levels.

(1) First line of defence (embedded in business):

- advising and supporting the business through the identification of legal risks;
- facilitating an understanding of the implications of risks;
- assessing risks; and
- planning actions to remedy breaches.

To achieve this, firms need to ensure that the legal function has a good understanding of the business and its risks, and the business a clear understanding of legal risk; and legal and business staff are adequately skilled and incentivised to manage legal risk.

(2) Second line of defence (control and oversight function):

- responsibility for defining policies and procedural controls;
- defining risk appetite and the limits on that tolerance;
- measuring risk levels and assessing against appetite limits;
- reporting risks;
- ensuring remedial action is taken;
- generating management information;
- reviewing and challenging the effectiveness of policies and controls;
- possibly conducting risk stress tests;
- conducting ad-hoc audits;
- cross-check against existing reporting;
- assisting in root cause analysis; and
- capturing trends.

(3) The third line of defence (independent assurance):

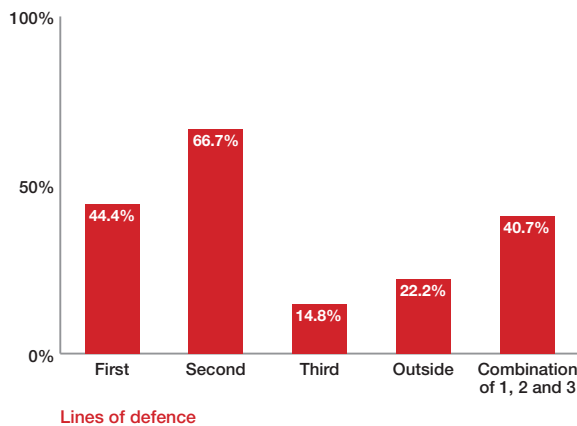
In more highly developed legal risk management systems, one might also expect to see lawyers playing a role in the independent assurance of the management of legal risk, in or alongside the third line of defence (which will include internal audit).

Firms¹ who were invited to the forum were asked to participate in a survey to gauge a picture of:

- where legal functions currently sit in respect of involvement in legal risk management;
- whether there are separate reporting lines for legal teams sitting in different lines of defence; and
- where in the three lines of defence firms believe the legal function should sit.

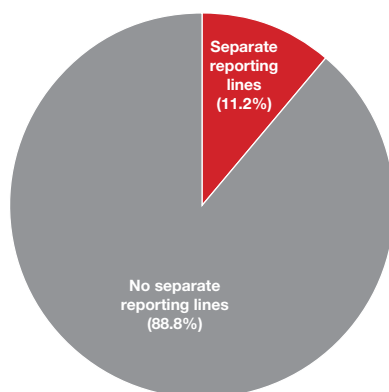
40.7% of respondents stated that they had legal teams sitting in more than one line of defence. The most common line of defence, including those within more than one line of defence, was the second line (where 66.7% of legal functions had a presence). 44.4% of legal functions (again, including those within more than one line of defence) had a presence in the first line of defence, and the minority (14.8%) in the third, with 22.2% of legal functions having a presence outside the three lines of defence (see diagram 1). Where legal teams sit wholly outside the lines of defence, there is a need to ensure that the right information for the effective management of legal risks is reported both horizontally and vertically within the organisation. 25.9% of respondents reported that if they had a free hand to design where they should sit, it should be in a combination of the first and second lines of defence; the second line being the most popular for those who wish it to be in more than one line, or just one line of defence. These statistics are perhaps unsurprising, not least in view of the fact that historically, legal and compliance risk management were often closely aligned.

Diagram 1



Where legal functions sit within more than one line of defence, firms may wish to consider whether line management needs to be separated, in order to preserve the difference in perspective the three lines of defence provides, which is what adds value to the enterprise as a whole and to the risk framework in particular. It seems that to do so may create a challenge for many firms as 88.8% of respondents whose legal teams have a presence in a combination of the three levels (ie, 40.7%) and who responded to the question, do not have separate reporting lines – only 11.2% of this constituent did (see diagram 2).

Diagram 2



There are two recent examples of where regulators, albeit overseas, have sought to hold in-house lawyers responsible for regulatory breaches. Whilst the cases are framed within the confines of national legislation, the issues are of broad interest.

In *Shafron v. Australian Securities and Investments Commission* [2012] HCA 18, the Australian High Court found that a general counsel, who also fulfilled the role of company secretary, was responsible for failing to properly advise the board and CEO about required disclosures to the Australian Stock Exchange. The court held that Mr Shafron acted as an officer of the company in respect of all of his responsibilities, including those of general counsel. He contended that his conduct was as, or 'in the capacity of', general counsel, not as, or 'in the capacity of', company secretary. The court rejected this argument, contending that Mr Shafron's responsibilities as company secretary and general counsel were not divisible and must be viewed as a whole.

In the US, the Securities Exchange Commission sought to make a former general counsel of an investment bank, Theodore Urban, liable for failing to supervise a rogue broker for whom he had no line management responsibility. The administrative judge held that since Mr Urban was aware of an issue with a broker and became involved in addressing red flags, he effectively assumed supervisory responsibility for the broker, particularly given that his views were regarded as authoritative and his recommendations were generally followed by the business (although not in this instance). The administrative judge at first instance took the view that Mr Urban had in fact discharged his obligations as supervisor competently; the SEC's appeal was dismissed as the Commissioners were divided on both issues.

The suggestion that such involvement could amount to an assumption of supervisory responsibility remains troubling, particularly when one considers the extension of the approved persons regime, beyond the controlled function for which the individual is approved, to any other functions performed by the individual in relation to the carrying on of a regulated activity by his/her firm.

Where the legal function sits within an organisation is critical, not least because it may determine what information lawyers can access, assess, monitor and advise on. It can also influence how the rest of the organisation perceives lawyers. On one view, lawyers should be embedded into the business, even though traditionally in-house lawyers may have seen themselves as being a step back from the business, possibly as a result of professional training, or conservatism. If lawyers are embedded in the business, they will need to have the courage and the skills to make commercial risk decisions.

However, there is also a need to ensure that “getting comfortable” (i.e., concluding that what the business wants does not generate unacceptable legal risk) does not mean that the legal risk manager succumbs to collective rationalisation or group think – or that lawyers become so close to the business that they are no longer able to stand back and assess the issues independently and with professional detachment.

Research² also suggests that there is a tendency, at least in periods of growth and expansion, for lawyers who are risk-preferrers to be those most likely to have been successful within organisations. The critical decision here for the firm is to determine the extent to which they constrain lawyers’ freedom to lean against strategic aggressiveness where such a strategy may pose legal risks, or risk finding themselves at competitive disadvantage.

Should in-house lawyers be subject to regulatory oversight?

Regulators are now seeking to place heightened importance on legal risk management in the wake of the financial crisis. There has been a definite shift in the tone of the UK regulators’ expectations of the legal function and a suggestion that it should take greater responsibility for, and play a more proactive and forward looking role in, legal risk management. Further, if the suggestion mooted by the PRA (that a ‘legal’ controlled function might be incorporated into the Approved Persons’ regime) is carried forward, this could bring the nature and competence of legal advice provided to a firm by such in-house lawyers within the scope of financial services regulation.

On one view, this could enhance the business’ perception of the value of the legal function. Furthermore, to the extent that a legal function is involved in making risk decisions or indeed undertaking

risk monitoring/control functions that are legitimately part of the systems which the regulator requires firms to put in place, rather than flagging issues or providing advice, then one can see that there is a genuine interest on the part of the regulator to supervise, review and where appropriate, sanction that conduct.

However, bringing lawyers within the regulators’ jurisdiction would have significant implications. Making in-house legal advice subject to the scrutiny of financial services regulators would represent a significant erosion of a firm’s right to legal privilege, a right recognised by section 413 of the Financial Services and Markets Act 2000³, recognised by the English common law, and which the European Court of Human Rights held in *Campbell v United Kingdom* [1992] 15 EHRR 137 to be part of the right to privacy guaranteed by Article 8 of the European Convention of Human Rights. Privilege attaching to the advice of salaried legal advisers received judicial recognition from the Court of Appeal in *Alfred Crompton Amusement Machines Ltd v Customs and Excise Commissioners (No 2)* [1972] 2 QB 102 – although the communications of a corporation with an in-house legal adviser are internal to the corporation, nevertheless the adviser is performing the same function as the lawyer in independent practice.

If some or all in-house lawyers are to become subject to regulatory oversight, the firm would no longer be able to exchange information with those lawyers in confidence, since as an approved person, the lawyer would be subject to notification obligations. This might then lead firms to consult external lawyers at a much earlier stage when potential regulatory issues arise instead of fostering the more open dialogue which Martin Wheatley has advocated.

It would also produce the somewhat peculiar result that the financial services regulator, by virtue of requiring an approved legal adviser to be competent and capable, would effectively assume responsibility for judging the quality of legal advice given to the firm by the approved legal adviser, and for issuing sanctions if the advice falls below the standard the regulator expects. Would the financial services regulator then impose its own standards for in-house lawyers, and would these harmonise with the professional obligations and the oversight and discipline of the Solicitors Regulation Authority (SRA) or the Bar Standards Board, or would approved in-house lawyers potentially face two competing sets of professional obligations?.

Consequential liability for lawyers

A key question flowing from this debate is – when should lawyers be responsible for client wrong-doings, particularly when they have provided wholly competent and accurate advice? To what extent should the moral imperative to be responsible for the effects of ones’ actions on others be applicable to lawyers? The response is explored in detail in “Consequential responsibility for client wrongs: Lehman Brothers and the regulation of the legal profession” David Kershaw (Professor of Law at the London School of Economics) and Richard Moorhead (Professor of Law and Professional Ethics at University College London) ((2013) 76(1) MLR26–61) and briefly summarised here. Kershaw and Moorhead propose that lawyers should be held accountable through professional regulation where: they are aware (or ought to be aware) that there is a real substantial and foreseeable risk that any proactive assistance the lawyer gives will lead to the client committing a wrong (a crime, breach of civil law or regulations).

The principles of the SRA’s Code of Conduct provide a core set of duties which, in addition to acting with competence, independence, integrity and in the best interests of the client, require lawyers to ‘uphold the rule of law and the proper administration of justice’ as well as requiring lawyers not to do anything that diminishes the public’s trust in the profession. Where the principles conflict, the SRA guidance states that the principle which takes precedence is the one which best serves the public interest in the particular circumstances, especially the public interest in the proper administration of justice.

Kershaw and Moorhead argue that in practice, the duty towards the client is most likely to prevail, due to financial and social pressures, lawyers’ culture, and because the regulations provide no contextually relevant guidance on the application of the very broad standards and are silent on transactional lawyers’ obligations. They therefore propose that there should be a clear and precise articulation of consequential responsibility in the regulations, and that the regulations must be effectively enforced.

Whilst it is clearly not acceptable for lawyers to conspire in a client’s wrongdoing, and that it is right that lawyers should be aware of the context of their advice, most participants suggested that the proposed bar was being set too high, though some thought it was appropriate.

Kershaw and Moorhead highlight that their proposal may not sit comfortably with the dominant idea that a lawyer’s role is to act zealously in its client’s interests. They argue that a case study based on the Lehman 105 transactions and the opinions issued to support these transactions suggest that it is unworkable in the complex and uncertain financial regulatory environment, even given the difficulties in predicting a client’s subsequent actions and determining whether they will be or will not be unlawful. Lawyers could and should protect themselves by being alive to red-flags and should be expected to ask more questions of the client if risks are perceived, such as ‘why are you doing this?’ or ‘what are you using the advice for?’.

They acknowledge the risk that imposing consequential responsibility may undermine the lawyer’s role as a ‘trusted adviser’ and the fundamental right of access to legal advice. It may also chill beneficial legal creativity. However, Kershaw and Moorhead argue that such concerns may be alleviated if consequential responsibility does not apply to all lawyering activities, but only to proactive lawyering (eg, giving a legal opinion), as opposed to reactive lawyering (eg, simply informing a client of their legal position). They acknowledge the scope for argument about the precise boundary between reactive advice and active assistance.

David Kershaw and Richard Moorhead’s proposals raise some concerns. How far would a lawyer have to go to satisfy himself that a client will not be committing a wrong? At what point would lawyers have to police the motives of clients? Should lawyers be required and entitled to information from the client’s auditors? What if a transaction is perfectly legal in one jurisdiction, but may be questionable in another? At what point should a lawyer be aware that their advice could lead to a wrong? With regulators taking a keener interest in the role of professional advisers, the paper is a timely reminder of the need for lawyers to be vigilant that about ethical concerns around their work for clients.

Conclusion

There is little doubt that the role of lawyers in financial institutions is coming under increasing scrutiny and that in-house lawyers are being encouraged to depart from the traditional role of provider of technical advice, to 'trusted adviser'. Lawyers are encountering practical challenges in identifying, assessing, monitoring and reporting risks. Increasing expectations of regulators and the suggestion that in-house lawyers should be subject to regulatory oversight, mean that the challenges are set to continue. Challenges also exist in the integration of legal functions within wider risk management systems, and our survey indicates that more could be done to separate line management where legal functions straddle more than one line of defence, to avoid the risk of undermining the governance of the origination, control and independent assurance of legal risk. There are also of course ample risks for lawyers and the extent that lawyers should be responsible for client wrongs, in circumstances where they have provided accurate advice is an area which deserves more debate.

Endnotes

- 1 There were 27 respondents to the survey, from firms representing a cross-section of the industry. All responses are confidential.
- 2 "Getting (Too) Comfortable: In-house Lawyers, Enterprise Risk and the Financial Crisis" 2011
Donald C. Langevoort, Georgetown University Law Center,
langevdc@law.georgetown.edu
Georgetown Public Law and Legal Theory Research Paper
No. 1-135
Georgetown Business, Economics and Regulatory Law Research
Paper No. 11-27
- 3 Section 413 of the Financial Services and Markets Act 2000 recognises that persons cannot be required to produce or disclose protected items (essentially privileged communications).

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Karen is a partner working in Herbert Smith Freehill's financial services regulatory practice. She has advised and acted for a wide variety of financial institutions in relation to regulatory matters and disputes in the UK and overseas. Karen now concentrates on providing technical advice on regulatory issues, analysing new law and regulation, and ensuring that the firm and its clients are at the forefront of regulatory law and practice. Formerly a prosecutor with the Commonwealth DPP in Australia, Karen has served secondments at the FSA and recently acted as Head of Regulatory in the legal function of a large commercial banking group.

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Julia Black joined the Law Department of the LSE in 1994. She completed her first degree in Jurisprudence and her DPhil at Oxford University. Her primary research interest is regulation. In 2001-2 she received a British Academy/Leverhulme Trust Senior Research Fellowship and in 2007-8 was a Visiting Fellow at All Souls College, Oxford. She has written extensively on regulatory issues in a number of areas, and has advised policy makers, consumer bodies and regulators on issues of institutional design and regulatory policy. She is Director of the Law Department's Law and Financial Markets Project and the Short Course on Financial Services and Markets Regulation. She is also a research associate of the ESRC Centre for the Analysis of Risk and Regulation (CARR), based at LSE.

Notes

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