

**Proposed amendments to rule 3 (conflicts of interest) and rule 4 (duties of confidentiality and disclosure) of the Solicitors' Code of Conduct 2007**

Consultation paper

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# 1. Introduction

- 1.1 The Solicitors Regulation Authority's (SRA) Rules and Ethics Committee invites views on proposals for amending rule 3 (conflict of interests) and rule 4 (duties of confidentiality and disclosure) of the Solicitors' Code of Conduct 2007. The proposals are not mutually dependent and one could be adopted without the other.
- 1.2 The proposal to amend rule 3 would increase the exceptions under which firms can act for sophisticated clients with conflicting interests where the clients give informed consent. It represents a significant extension of the circumstances in which a law firm might act for two clients whose interests conflict in a particular matter and could involve, for example, two teams in the same firm conducting negotiations with each other. The amendment to rule 4 would extend the circumstances in which information barriers can be used without the consent of the client whose confidential information is being protected.
- 1.3 Although the amendments are of primary concern to those who act for sophisticated clients, their potentially broad effect means that we welcome comments from all practitioners, clients, academics, regulators and other professions. We are particularly keen to have views from in house lawyers and private practitioners representing large companies and public bodies and from those who have experience of the practical operation of conflict rules in other jurisdictions.

# 2. Background

The relevant provisions of rule 3 and rule 4 are **annexed**.

- 2.1 The main provisions in rules 3 and 4 which are affected by the proposals are these:

## Rule 3

- Conflict is defined in rule 3 as a conflict between the duty to act in the best interests of two or more clients in a matter, or related matter. The rule makes it clear that a firm must not act where there is a conflict.
- Rule 3 sets out two limited exceptions to the general prohibition on acting where there is a conflict. These permit a firm to act with the informed consent of the clients concerned:
  - a) where the clients have a substantially common interest; or
  - b) where the clients are competing for the same asset.

The guidance makes clear that the second exception is only really applicable to specialised areas of legal services and where the clients are sophisticated users of those services.

## Rule 4

- Rule 4 deals with the duties of confidentiality and disclosure and the way in which these interact.
- It includes a duty not to put at risk the confidential information of a client or former client by acting for another client where that information would be material and the work for the new client would be adverse to the interests of the former or other client.
- Firms can act under stringent conditions set out in the rule where there would otherwise be a breach of this duty if they can put in place arrangements (i.e. information barriers) to protect the confidential information at risk. The first situation where this is allowed is where the clients give informed consent and agree the arrangements. The second allows a firm **to continue** to act for a client without the consent of the client whose information is being protected where:
  - a) the firm is already acting for the client before the adversity becomes apparent; and
  - b) an information barrier is put in place which meets the standards required by the law.

2.2 These rules were introduced in 2006 (having been conceived in 2000) and were intended to:

- give greater clarity to the circumstances in which firms can accept or must refuse instructions;
- bring the rules more closely into line with the law and the conflict rules in other jurisdictions, particularly Europe;
- give flexibility for larger firms to provide services to their sophisticated clients by not unnecessarily restricting their choice of solicitor;
- retain proportionate restrictions to address risk to all clients.

2.3 Since the current rules were conceived in 2000, the conflict rules in other jurisdictions and the law have been subject to further development. Arguments have been put forward by the City of London Law Society (CLLS) that for solicitors in England and Wales and their clients not to be prejudiced by being unnecessarily restricted in terms of choice of lawyer, rules 3 and 4 need to be realigned to reflect these changes. The paper will examine the question of what is a necessary restriction in more detail in the sections dealing with the regulatory arguments.

2.4 Further, the application of the rules to practical situations over the last two years has exposed some problems. The chief difficulty in relation to rule 3 has been the extent

of the application of the exception which allows firms to act with the clients' consent where the clients have a "substantially common interest". The term "substantially common interest" is not defined and the guidance can give only a few examples. Some firms report they are finding it difficult to judge, or anticipate, when this exception can properly apply in large and complex transactions, especially as the nature of the transactions often develops as they are negotiated. The proposed amendment is one way of addressing the problem. It could also potentially be addressed by a closer definition of "substantially common interest" or by applying a total prohibition on acting where there is any conflict (but this would have implications for all firms, not just those serving sophisticated clients).

### *The European and USA conflict rules*

- 2.5 Most, if not all, US States permit firms to act in conflict situations where the clients concerned are able to give informed consent. This is in line with the ABA model rules. The European position is varied and less clear. The German Code appears to be similar to the USA position but other European Codes could be read as only allowing firms to act where the consent relates to situations involving a risk of conflict rather than an actual conflict. Comparisons with other jurisdictions, however, can be difficult because the conflict rules of other countries have to be read in the context of the entire Code they form part of and also in the context of the legal system of the country in question.

### *The legal position*

- 2.6 The rules should not be more permissive than the law, although they can be more restrictive if there is a good regulatory reason. At law, a firm can accept instructions from clients who have a potential conflict of interest (subject to disclosure and obtaining informed consent from such clients).
- 2.7 The Privy Council in *Clark Boyce v Mouat* contemplated that either a solicitor or a firm could act with informed consent. In that case, the solicitor was advising a mother and son on a mortgage of the mother's home to secure lending to the son but she did not seek any legal advice on the advisability or otherwise of entering into the arrangement, with the result that the solicitor's role was "execution-only". It is unclear, therefore, the extent to which this case can be regarded as authority for saying that the law allows a firm to act where there is an actual conflict. What is clear, however, is that the law requires that solicitors – and also their firms - act with undivided loyalty to each client and in each client's best interests. Rule 3 as currently drafted does, in carefully controlled circumstances, permit firms to act with client consent where there is a conflict.
- 2.8 In relation to the protection of confidential information and the proposed change to rule 4, it is clear that the courts permit information barriers without the consent of the client whose information is being protected provided very stringent conditions are satisfied.

### 3. Rule 3 – (conflicts of interest)

#### 3.1 The proposals for change

3.1.1 As outlined above, there are two limited exceptions to the prohibition against firms acting where there is a conflict of interests between two or more clients. These allow firms to act with informed consent where the clients have either a common interest or, essentially in relation to sophisticated clients, where they are competing for the same asset.

3.1.2 The proposal would substantially extend these exceptions to allow firms to be able to act with the informed consent of two or more clients in any other situation, not involving litigation, where there is a conflict of interests. This represents a major change and needs to be considered very carefully. Because of the increased risks it represents for clients it would have to be subject to correspondingly tight controls, for example, such as to require that:

- the clients are sophisticated (the term sophisticated would have to be defined and could be limited to those that have their own in-house legal department or who have obtained separate legal advice on the issue);
- the clients are able to give informed written consent after any significant difference in bargaining power between them had been made clear;
- the clients are told that if the firm acts for both/all of them different teams within the firm may have to negotiate with each other on behalf of each client;
- there is full transparency of the consents given by each client to ensure that they understand what they and the other clients are agreeing to;
- there is compliance with rule 1 and, in particular, the requirement that the firm must be able to act in the best interests of each client, both at the outset and as the transaction continues;
- agreed measures to protect the confidential information of the clients must be put in place;
- agreement must be reached at the outset as to what happens if joint representation becomes untenable;
- since commercial clients tend to express their dissatisfaction directly rather than by making complaints to the SRA or Legal Complaints Service (LSC), the firm should remind the in-house/independent lawyers acting for the clients that any concerns they have that the firm has failed to act in the best interests of their respective clients, or otherwise in breach of the rules, may be referred to the SRA or LCS.

- 3.1.3 Other record keeping requirements could be imposed but would have to be considered carefully to ensure that they were proportionate to the risk and added to the controls suggested above.

## 3.2 Reasons for the proposals and the regulatory arguments

### *Reasons for the proposals*

- 3.2.1 The main reasons for the proposed amendment have their origins in issues raised by the City of London Law Society (CLLS. ). These reasons, and the circumstances in which the CLLS anticipate the amendment would be used, are these:
- If a sophisticated client wants to agree that its law firm (through a separate team) can act for another party, then it should be able to do so without regulatory restriction. Use of the proposed relaxation would most usually arise where two entities, which are trying to conclude a deal, both habitually use the same law firm. Neither wishes to move to another firm because this would involve educating the new firm in its business and having to do this would increase costs and delay and complicate the transaction. Rather, both would prefer to use their respective teams in the single firm.
  - It is not anticipated that the reform would lead to very many instances of a conflict being waived. The clients who would most want reform along the lines proposed are those who regularly do deals involving specialist areas of law or business and who have, therefore, developed a relationship with particular individuals at law firms. These individuals have, as a result, built up a deep knowledge about the clients business and approach. The clients are likely to be those operating in specialist areas such as banks, private equity houses, fund managers, project companies, aircraft leasing companies etc.
  - Lawyers in some other European countries and most States, if not all, in the USA are generally able to act for clients who "waive" a conflict by giving informed consent to a firm acting and the SRA rules are out of line in preventing clients from giving such consent.
  - The law does not prevent clients consenting to firms acting where there is a conflict.
  - The change is necessary to ensure that London continues to be seen as a place where business can be transacted quickly and efficiently, without unnecessary regulatory restrictions.

## *Regulatory arguments*

- 3.2.2 The SRA is committed to risk based and proportionate regulation. This means that rules must only be used to address real risk and the level of protection must be proportionate to that risk. The current rules which deal with conflict and the duties of confidentiality and disclosure seek to ensure that every client can be sure that their solicitor or firm will be able to protect and promote their interests without regard to the interests of another client.
- 3.2.3 When drafting rule 3 the view was taken that the limited exceptions to the approach that a conflict could not be waived were justified because it is sometimes in the best interests of clients to be able to instruct the solicitor of their choice despite an element of conflict. These are cases where the relatively small area of conflict does not justify the dislocation and expense of separate representation and it would be disproportionate to force clients in these circumstances to take separate advice. There are also situations involving sophisticated clients where it was clear market practice in the City for clients to accept that their firm might act for another client competing for the same asset.
- 3.2.4 In relation to the proposed amendment to rule 3, risk to clients, the public at large and the reputation of the profession needs to be carefully evaluated and there are some evident potential risk areas which need consideration.
- 3.2.5 Whilst there is evidence that this is what the clients want and that they may be unconcerned about the confidential information the firm holds about the other client(s), it is only the firm (usually through its conflicts checking team) that can objectively assess whether it is in the best interests of each client that that client continues to be represented by the firm. This may raise questions about whether the dominant client could be favoured or about whether each client can be given the same, or enough, information to make its own informed decision about joint representation. It also raises questions about a firm's internal dynamics and the associated pressures placed on those making decisions about whether the firm can continue to act in the light of representations made by the teams acting for the individual clients.
- 3.2.6 The proposed amendment would also allow separate teams within a firm to act in a far wider spread of conflict situations, including negotiating situations, than under the current rule. This creates a situation of teams effectively acting as firms within a firm with the extensive use of information barriers. Is this acceptable where the conflict is more than very minor or is it likely to lead to an erosion of a firm's ability to give independent advice or to create other risks? Is it possible to for a firm to discharge its duty of loyalty and to act in the best interests of each client when the clients are in a negotiating position?
- 3.2.7 Another potential problem arises from the scope of the amendment. Although it is argued that it would only be used in limited situations (see paragraph 3.2.1) it is actually very wide and would allow firms to act for clients in any situation of conflict (litigation excluded) where the clients consented. The only



regulatory control would be whether this remained in the best interests of each client. If the circumstances of conflict in which a firm can act are widened does this increase the difficulty in identifying the point in the transaction where the firm should cease to act?

- 3.2.8 Because sophisticated clients are often public companies subject to investment by both individuals and institutions, including pension funds, there is an argument for saying that there is a strong public interest in ensuring that they are properly and objectively represented. For the reasons listed above, or for any other reason, is this likely to be impaired?
- 3.2.9 There are, however, also clear arguments for the proposed amendment.
- 3.2.10 If the clients' freedom to instruct the firm of their choice and the benefits that that brings outweighs the risks which arise from the same firm acting for all of them, it may be disproportionate to prevent it. The clients are able to take independent advice if need be and can decide whether the inherent risks are outweighed by the benefits and this is a decision they should be allowed to make if they believe this is the most effective way of conducting their business.
- 3.2.11 The core duty, rule 1, requiring a firm to act in each client's best interests, although through separate teams, would operate as a brake on firms acting in situations where the conflict was simply so pervasive that it would not be possible to act in compliance with this duty. If firms acted in breach they would know that they ran the commercial risk of losing a client and the regulatory risk of being found in breach of rule 1.
- 3.2.12 Finally, the proposal would bring some certainty as to the extent to which firms could act for sophisticated clients in conflict situations. No difficult decisions would have to be made about where the boundaries of the "substantially common interest" exception lay. All that would be required would be compliance with the conditions which would accompany the amendment and with rule 1.

## **4. Rule 4 – (Duty of confidentiality)**

### **4.1 The proposals for change**

- 4.1.1 The proposal to amend rule 4 would allow a firm holding confidential information for one client to accept instructions from a new client where there is adversity between the clients without the first client's consent. At present, the rule only allows this where the firm has already started acting for the new client before the problem arises. The proposal would extend this to allow a firm to take on instructions in this situation provided an information barrier which complies with the requirements of the common law can be put in place.

## 4.2 Reasons for the proposals and the regulatory arguments

### *Reasons for the proposals*

#### 4.2.1 The arguments in favour are these:

- if a common law compliant information barrier is put in place, confidential information is protected to the very high standards required by the law and further protection is unnecessary;
- the need to seek consent may increasingly lead to clients instructing firms tactically to deny their competitors access to the best specialist advice;
- the rule prevents law firms in this country acting in situations where other professional advisers and overseas law firms are able to do so.

### *The regulatory arguments*

4.2.2 Rule 4, which deals with the duty of confidentiality, already permits information barriers where the confidentiality of one client would otherwise be put at risk to allow a firm to complete a matter for another client. It was felt that the stringent common law requirements that the information barrier had to comply with would limit its use to circumstances involving sophisticated clients and the largest of firms.

4.2.3 At the time the rule was finalised it was decided, however, that firms should not be allowed to **accept** instructions without consent from the client whose information was being protected even if the firm could put a legally compliant information barrier in place. This was because it was felt the risks of information barriers should be limited to the circumstances where the client's work was partially completed when the problem occurred. In other words the client whose work was partially completed could be put at much greater disadvantage by being forced to instruct another firm than the potential client for whom no work had been undertaken which was merely denied the firm of its choice.

4.2.4 The changes to the confidentiality rule being proposed would allow instructions to be accepted, rather than completed, with the use of an information barrier without the consent of the client whose information needed to be protected. The information barrier would still have to comply with the stringent requirements of the law which continue to prevent most firms from being able to use them without client consent. The regulatory argument in support of this extension is that if the legal requirements can be met it is illogical to have a distinction which allows a firm to complete instructions but not accept instructions using an information barrier. Further, since the courts

laid down clear markers as to what was required in terms of an information barrier, firms have adapted their structures and procedures to comply with the law.

## 5. Questions

### *Rule 3*

1. What do you regard as the benefits the proposed change would bring? Do they outweigh the potential risks?
2. What do you view as the main risks related to the proposed amendment?

In particular:

- what are the difficulties inherent in sophisticated clients giving informed consent and in weighing up the risks and benefits of their firm acting for other parties where there is a conflict;
  - what are the potential problems for the firm, including the dynamics between the teams acting for the individual clients and those making the decisions on whether the firm can act – and also any conflict between the interests of the firm and the clients; and
  - do you see risks for the public at large and reputational risks, for example, through companies not getting wholly independent advice?
  - can a firm properly discharge its duties to each client when different teams within the firm are negotiating on behalf of their respective clients?
3. Overall, do you believe that the proposed amendment is acceptable in terms of the level of risk, given that it will apply only to sophisticated clients?
  4. Do you agree with the suggested definition of “sophisticated client”, namely those that have their own in house legal department or have obtained independent legal advice on the issue? If not, what definition would you favour?
  5. If the amendment is agreed, what conditions would you suggest should be attached to the rule change to ensure proper protections for clients?
  6. Do you have any other comments on the proposal?

### *Rule 4*

7. Should firms be able to **accept** instructions from a new client, as opposed to completing instructions as at present, under rule 4.05 and subject to the same conditions requiring an information barrier which complies with the high level of protection required by the common law? If you believe this creates unacceptable new risks to clients please let us know what you believe these risks to be.

## 6. How to respond

For information on how to respond, please visit our website.

- Go to [www.consultations.sra.org.uk](http://www.consultations.sra.org.uk).
- Select **Conflict and confidentiality rules – proposed amendments**.
- Click **How to respond**.

We are unable to acknowledge receipt of responses. We take this opportunity to thank you for your response.

### Submission deadline

The deadline for responses is 31 March 2009.

# Annex

## Rule 3 – Conflict of interests

### 3.01 Duty not to act

- (1) You must not act if there is a conflict of interests (except in the limited circumstances dealt with in 3.02).
- (2) There is a conflict of interests if:
  - (a) you owe, or your firm owes, separate duties to act in the best interests of two or more clients in relation to the same or related matters, and those duties conflict, or there is a significant risk that those duties may conflict; or
  - (b) your duty to act in the best interests of any client in relation to a matter conflicts, or there is a significant risk that it may conflict, with your own interests in relation to that or a related matter.
- (3) For the purpose of 3.01(2), a related matter will always include any other matter which involves the same asset or liability.

### 3.02 Exceptions to duty not to act

- (1) You or your firm may act for two or more clients in relation to a matter in situations of conflict or possible conflict if:
  - (a) the different clients have a substantially common interest in relation to that matter or a particular aspect of it; and
  - (b) all the clients have given in writing their informed consent to you or your firm acting.
- (2) Your firm may act for two or more clients in relation to a matter in situations of conflict or possible conflict if:
  - (a) the clients are competing for the same asset which, if attained by one client, will make that asset unattainable to the other client(s);
  - (b) there is no other conflict, or significant risk of conflict, between the interests of any of the clients in relation to that matter;
  - (c) the clients have confirmed in writing that they want your firm to act in the knowledge that your firm acts, or may act, for one or more other clients who are competing for the same asset; and
  - (d) unless the clients specifically agree, no individual acts for, or is responsible for the supervision of, more than one of those clients.
- (3) When acting in accordance with 3.02(1) or (2) it must be reasonable in all the circumstances for you or your firm to act for all those clients.
- (4) If you are relying on the exceptions in 3.02(1) or (2), you must:

- (a) draw all the relevant issues to the attention of the clients before agreeing to act or, where already acting, when the conflict arises or as soon as is reasonably practicable, and in such a way that the clients concerned can understand the issues and the risks involved;
- (b) have a reasonable belief that the clients understand the relevant issues;  
and
- (c) be reasonably satisfied that those clients are of full capacity.

### **3.03 Conflict when already acting**

If you act, or your firm acts, for more than one client in a matter and, during the course of the conduct of that matter, a conflict arises between the interests of two or more of those clients, you, or your firm, may only continue to act for one of the clients (or a group of clients between whom there is no conflict) provided that the duty of confidentiality to the other client(s) is not put at risk.

## Rule 4 – Confidentiality and disclosure

### Introduction

Rule 4 sets out provisions for dealing with the protection of clients' confidential information and the duty of disclosure owed to clients.

## Rule 4 – Confidentiality and disclosure

### 4.01 Duty of confidentiality

You and your firm must keep the affairs of clients and former clients confidential except where disclosure is required or permitted by law or by your client (or former client).

### 4.02 Duty of disclosure

You must disclose to a client all information of which you are aware which is material to that client's matter regardless of the source of the information, subject to:

- (a) the duty of confidentiality in 4.01 above, which always overrides the duty to disclose; and
- (b) the following where the duty does not apply:
  - (i) where such disclosure is prohibited by law;
  - (ii) where it is agreed expressly that no duty to disclose arises or a different standard of disclosure applies; or
  - (iii) where you reasonably believe that serious physical or mental injury will be caused to any person if the information is disclosed to a client.

### 4.03 Duty not to put confidentiality at risk by acting

If you hold, or your firm holds, confidential information in relation to a client or former client, you must not risk breaching confidentiality by acting, or continuing to act, for another client on a matter where:

- (a) that information might reasonably be expected to be material; and
- (b) that client has an interest adverse to the first-mentioned client or former client,

except where proper arrangements can be made to protect that information in accordance with 4.04 and 4.05 below.

### 4.04 Exception to duty not to put confidentiality at risk by acting – with clients' consent

- (1) You may act, or continue to act, in the circumstances otherwise prohibited by 4.03 above with the informed consent of both clients but only if:
  - (a) the client for whom you act or are proposing to act knows that your firm, or a member of your firm, holds, or might hold, material information (in



circumstances described in 4.03) in relation to their matter which you cannot disclose;

- (b) you have a reasonable belief that both clients understand the relevant issues after these have been brought to their attention;
  - (c) both clients have agreed to the conditions under which you will be acting or continuing to act; and
  - (d) it is reasonable in all the circumstances to do so.
- (2) “Both clients” in the context of 4.04(1) means:
- (a) an existing or former client for whom your firm, or a member of your firm, holds confidential information; and
  - (b) an existing or new client for whom you act or are proposing to act and to whom information held on behalf of the other client is material (in circumstances described in 4.03 above).
- (3) If you, or you and your firm, have been acting for two or more clients in compliance with rule 3 (Conflict of interests) and can no longer fulfil its requirements you may continue to act for one client with the consent of the other client provided you comply with 4.04.

#### **4.05 Exception to duty not to put confidentiality at risk by acting – without clients’ consent**

You may continue to act for a client on an existing matter, or on a matter related to an existing matter, in the circumstances otherwise prohibited by 4.03 above without the consent of the client for whom your firm, or a member of your firm, holds, or might hold, confidential information which is material to your client (in circumstances described in 4.03) but only if:

- (a) it is not possible to obtain informed consent under 4.04 above from the client for whom your firm, or a member of your firm, holds, or might hold, material confidential information;
- (b) your client has agreed to your acting in the knowledge that your firm, or a member of your firm, holds, or might hold, information material to their matter which you cannot disclose;
- (c) any safeguards which comply with the standards required by law at the time they are implemented are put in place; and
- (d) it is reasonable in all the circumstances to do so.

#### **4.06 Waivers**

In spite of 22.01(1) (Waivers), the Board of the Solicitors Regulation Authority shall not have power to waive any of the provisions of this rule.