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## SRA Risk Outlook 2014/15

The key risks to the regulatory objectives

July 2014





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# Foreword

Paul Philip

Chief Executive



To reform our approach to regulation and make it more proportionate, it is important that we are clear about why we regulate legal services. There are two core reasons for our approach. First, we want to ensure that consumers are properly protected; and that our protections are proportionate to their different needs. Second, we seek to ensure that the rule of law and proper administration of justice are secure.

Every regulator has a choice about being either proactive or reactive. We have a range of tools to deploy that can be used either to try to avoid certain events happening or to help pick up the pieces afterwards. When deciding which option is appropriate we must consider the seriousness of the issue, the ability of different client groups to protect their own interests, the likelihood of occurrence and the cost and benefit of each option. These are all factors we consider when we assess risk.

Our overall approach is to be proactive – to provide a framework (the Handbook) for legal practice that avoids most of the risks that consumers might face and supports the rule of law. We are also proactive in our identification of risk; helping firms to manage risk and targeting our resources accordingly.

The Risk Outlook identifies the priority risks that we need to manage if we are to deliver effective and proportionate regulation. It is important we continue to refresh this document to keep pace with the wider changes taking place in the legal services sector.

Most of all, we want solicitors and firms to manage risks themselves. Over recent years, our approach to regulation has provided greater freedom for lawyers to design and deliver services, to run their business and engage with the legal market as they see fit. But alongside that freedom comes responsibility. It is the responsibility of solicitors and firms to identify what might go wrong and what can be done to avoid it. This document should help firms to do that, by providing you with guidance, advice and insights to the risks we see in different parts of the legal services sector.

The Risk Outlook is one part of an ongoing programme to help firms to comply with our regulation. If we provide that advice and guidance, and you respond positively to support the rule of law and protect consumers, then together we can help the legal market grow. This will provide you with more opportunities to develop your business. Our focus can then be relentlessly turned on that small minority which either refuses to comply or is cavalier in its approach.

I welcome your feedback on this document and how you use it. We want to keep improving and you can help us do that.

A handwritten signature in black ink, appearing to read 'Paul Philip'.

Paul Philip  
Chief Executive

# Executive summary

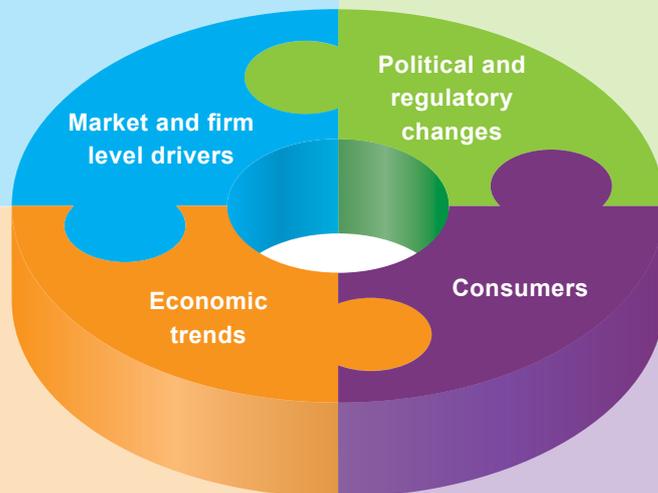
The Risk Outlook 2014/15 sets out an overview of key issues and trends in the legal services sector. It explains the key risks that we have identified to the regulatory objectives.

## Drivers of change

The legal services sector is a rapidly changing market. The factors driving this are summarised below:

- Financial difficulty and poor business management practices
- Consolidating legal market
- Group contagion
- Weaknesses in exit and succession planning
- Changes in the professional indemnity insurance market
- Increased variety of business structures
- Increased use of fixed fees.

- Reforms to criminal legal aid
- Personal injury and embedding the ban on referral fees
- Changes in tax arrangements for LLPs
- Changes in consumer credit licensing and court enforcement of procedural rules
- Drive to reduce regulatory burdens
- Reforms to legal education and training
- Poor or missing regulatory information.



- Economic recovery
- Growth in the number of property transactions, albeit subject to concerns about structural weaknesses in the housing market
- Likelihood of increased interest rates
- International economy and inter-jurisdictional work.

- Evidence of unmet legal needs
- Considering factors and circumstances that can make some consumers more vulnerable
- Balancing regulatory protection and cost.

The key risks in the Risk Outlook 2014/15 are detailed below:

## Current priority risks

### Misuse of money or assets

We are seeing a continuation of the trend we reported in the Risk Outlook 2013 of increased numbers of cases of misuse of money or assets. These are a great concern when client money is involved. Some of these cases are caused by poor systems and controls, whilst other cases involve unethical conduct. We have also seen a number of firms where financial difficulty has been a contributory factor leading to misuse of client money.

### Money laundering: inadequate systems and controls over the transfer of money

Law firms can handle large sums of money and can be attractive targets for those wishing to launder the proceeds of crime or otherwise disguise improper transfers of money. Managing this risk has increased in importance over the last year. We have received more reports of suspected money laundering through law firms, and we are investigating some serious cases. We are also concerned about the poor quality of suspicious activity reporting by firms in the legal sector.

### Bogus firms

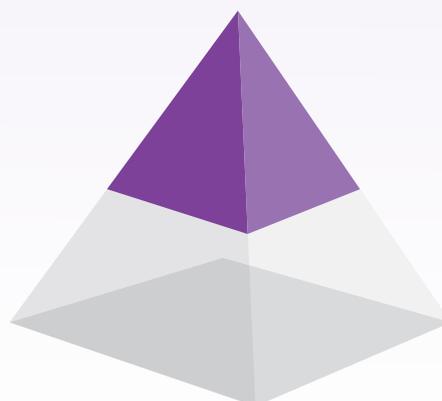
The term 'bogus firm' is used to describe situations where criminals take on the identity of a law firm in order to steal money or access information. We are seeing an increasing number of bogus firms, particularly those involving identity thefts of an existing firm or individual. Bogus firms are a risk to consumers losing money or confidential information. It is also in the interests of law firms to safeguard against this risk as it has the potential to lead to reputational damage and other negative impacts.

### Lack of a diverse and representative profession

There is limited evidence that improvements are being made to enhance the diversity of the legal services workforce. Making the profession more diverse and representative will lead to benefits in quality and access to justice. We have a clear regulatory rationale to focus on this issue, but it is also in the interest of law firms to ensure they are recruiting and retaining the best talent in their workforce.

### Failure to provide a proper standard of service: quality of legal services to vulnerable consumers

There is a range of evidence which suggests the standards of service and quality of legal advice sometimes fall below the level that can reasonably be expected by consumers. This can lead to detrimental impacts on the clients of a law firm, but may also lead to a wider negative effect on the proper administration of justice and rule of law. The impact may be worse when those affected are less able to look after their own interests. There are a wide range of factors and circumstances that could lead to some clients being more vulnerable.



## Other priority risks

### **Breach of confidentiality: information security and cybercrime**

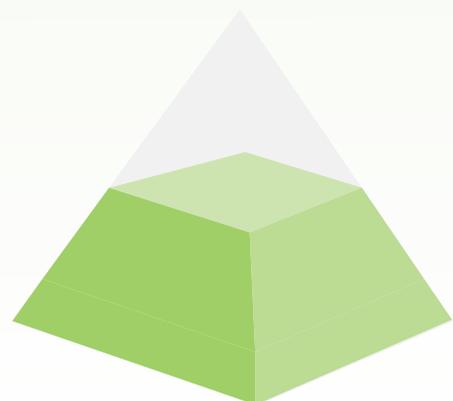
Keeping the affairs of clients confidential and secure is a key professional duty. Law firms need to be prepared for the increased risk to this duty that is presented by cybercrime. Criminals increasingly use the internet to target their victims. Cybercrime committed against law firms can be used to steal money, to facilitate identity theft or for industrial espionage. Our regulatory remit is primarily concerned with managing the risk that cybercrime presents to consumers. However, it also presents a wider risk to public confidence in the legal sector. For law firms, managing this risk is vital to their reputations and client relations.

### **Lack of independence**

Promotion of a client's interests, or a desire to maximise commercial return, should not override wider obligations to the public interest and the proper administration of justice. We acknowledge that the professional principles can, and do, come into conflict with each other. However, when professional principles come into conflict, the one that best serves the public interest, in the particular circumstances, prevails. There is an increasing trend towards corporate buyers of legal services, such as financial institutions and large multinational businesses, having sophisticated in-house legal departments. This can change the balance of power between the client and their legal advisor. Those we regulate must ensure they prioritise their obligations to act in the public interest, in accordance with their duties to court, and must resist client pressure which may adversely compromise their professional independence.

### **Failure to act with integrity or ethics: improper or abusive litigation**

Improper or abusive litigation is the misuse of legal proceedings (or the threat to bring proceedings) for unethical gains, either for the law firm, its clients or both. This is done by exploiting a client or third party's lack of knowledge of the law or the lack of resources available to them. We have seen several cases where the justice system has been manipulated so that a firm can increase its financial return. This type of litigation is contrary to a solicitor's duty to act in the public interest and has a significant negative effect on the public's perception of the profession.



## Changes from Risk Outlook 2013

The following diagram sets out each risk in comparison with how it was prioritised in the Risk Outlook 2013. Some risks have increased in significance and others have decreased. Factors such as financial difficulty are set out in this document as a driver of risk.

	Risk	Change from 2013	Key messages
Current risks	<b>Misuse of money or assets</b> Last year: Current risk		High numbers of cases continue to be reported. Underlying causes include financial difficulty and poor systems and controls.
	<b>Money laundering: inadequate systems and controls over the transfer of money</b> Last year: Emerging risk		We are dealing with an increasing number of cases, including some potentially serious matters. The nature of this risk varies between different types and size of firm.
	<b>Bogus firms</b> Last year: Not included		Many law firms and consumers have been targeted by these scams over the past year. They often involve identity theft of genuine law firms.
	<b>Lack of a diverse and representative profession</b> Last year: Current risk		There is limited evidence that progress is being made to tackle this issue.
	<b>Failure to provide a proper standard of service: quality of legal services to vulnerable clients</b> Last year: Emerging risk		We have seen evidence that indicates standards of service and quality should be a regulatory priority. We are particularly concerned where consumers are less able to look after their own interests.
Other priority risks	<b>Breach of confidentiality: information security and cybercrime</b> Last year: Not included		Cybercrime presents an increasing risk to client confidentiality. The risk affects a wide range of law firms.
	<b>Lack of independence</b> Last year: Not included		We have seen cases where pressure from influential clients has compromised firms' prioritisation of the public interest.
	<b>Failure to act with integrity or ethics: improper or abusive litigation</b> Last year: Potential risk		We continue to see examples of the justice system being misused. This is often connected to issues of ethics and integrity.
2013 risks that are presented as 'drivers' in this Risk Outlook	<b>Financial difficulty</b> Last year: Current risk	Driver	Although this is no longer presented as a 'key risk', we still find that it is a significant cause of many regulatory matters.
	<b>Lack of adequate succession or exit planning</b> Last year: Emerging risk	Driver	This factor can lead to a number of regulatory matters, such as abandonment or poor standards of service.
	<b>Group contagion</b> Last year: Potential risk	Driver	Group contagion can lead to the destabilisation of a law firm, and contribute to a number of risks to consumers and the public interest.
	<b>Failure to cooperate or comply</b> Last year: Current risk	Driver	There are a number of examples where a failure to provide important regulatory information has had an impact on our ability to manage risks. An example includes failure to notify us if a firm has not obtained insurance.
Not included	<b>Lack of due diligence over outsourcing arrangements</b> Last year: Potential risk		This broad category has been narrowed down to a stronger focus on managing risks presented by cybercrime to client confidentiality.
	<b>Lack of transparency in complex business structures</b> Last year: Potential risk		We continue to monitor this risk, but have seen limited new evidence over the last year for it to remain as a priority.

# Introduction

The Risk Outlook is our assessment of the key risks to the regulatory objectives. Its purpose is to:

- set out our view of the legal services sector
- demonstrate our priorities
- help law firms to manage risk
- explain the controls we use to manage these risks and act in the public interest.

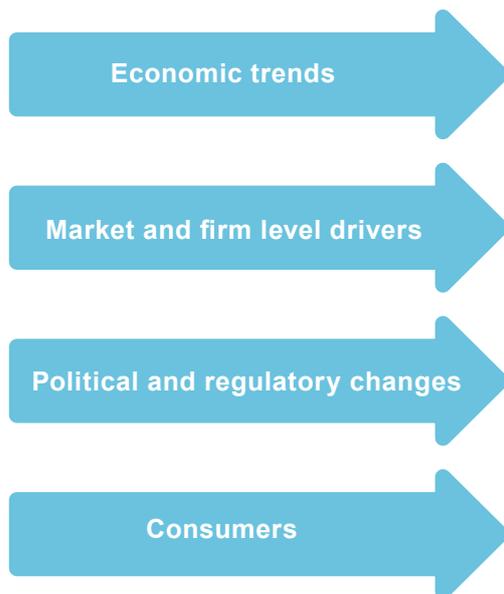
The Risk Outlook provides an overview of the factors that are driving risk in the legal services sector (Part A) and sets out the key risks to the regulatory objectives (Part B).

We have also included case studies and analysis of how the risk landscape has changed since the Risk Outlook 2013. The case studies are based on real events but names and details have been changed.

## The regulatory objectives<sup>1</sup>

- protecting and promoting the public interest
- supporting the constitutional principle of the rule of law
- improving access to justice
- protecting and promoting the interests of consumers
- promoting competition in the provision of legal services
- encouraging an independent, strong, diverse and effective legal profession
- increasing public understanding of the citizen's legal rights and duties
- promoting and maintaining adherence to the professional principals

### Part A: Drivers



### Part B: Risks



1. [Legal Services Act 2007](#)

## Understanding risk in different types of law firm

The legal services sector is made up of a wide range of different types of firm. It is a diverse market, ranging from sole practitioners, to firms with many branches, to large corporations.<sup>2</sup> Levels of risk will also be affected by other factors, including geography, client group and the type of legal service being provided.

Firms should consider how far they are exposed to the risks we have set out. To help with this, we have highlighted where a risk is relevant to particular types of firm.

Although some risks are more frequently associated with certain types of firm, many risks are present across the whole market. For example, we have seen problems with misuse of client money and failure to identify or report money laundering in all types of firm, from small high street practices to large corporate firms.

We also recognise that around 18 percent of solicitors work in-house.<sup>3</sup> The risks associated with these solicitors will be different, and in some cases lower. However, many risks highlighted in this document will still be relevant.

## Our evidence

Our assessment of risk is based on a wide range of evidence. We look at trends in what is reported to us by members of the public, clients of law firms, and our stakeholders, such as the Legal Ombudsman. We also review the cases we have investigated and acted upon. We do our own research and monitor the work of academics who study the legal services sector. We have also consulted with firms we regulate and drawn on the experiences of our staff.

We want to encourage law firms to discuss their views of the risks with us. We will all have a better understanding of the issues if we have an open dialogue with those we regulate.

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2. Previous research ([A framework to monitor the legal services sector](#), Oxera for the Legal Services Board, 2011) has defined different market segments and brought greater consistency to our understanding of the different groups of law firms. In this document we do not rely heavily on technical definitions, preferring to highlight broad groups of firms or market segments where certain risks might be more prevalent.

3. [The role of in-house solicitors](#), Oxera, Solicitors Regulation Authority, February 2014

## Part A:

# Market assessment - drivers of change

This section sets out our assessment of the factors that are driving risk in the legal services sector.

We have divided this chapter into four parts:

- economic trends and outlook
- market and firm level trends
- regulatory and political changes
- consumer behaviour and expectations.

### Economic trends

Wider economic conditions drive many of the risks we see in the legal services sector. Many of the firms we have engaged with on grounds of financial difficulty had failed to monitor and react to economic changes in the markets they operate in. Some key trends are set out below:

#### Economic recovery

The UK economy is growing after a period of low or negative growth. At the end of the first quarter of 2014, economic growth was 3.1 percent higher than a year ago.<sup>4</sup> This is helping drive demand for many types of legal services and we are already seeing law firms respond to this.<sup>5</sup> For example, strong growth in the financial and professional service sector, in London in particular, is creating more opportunities for law firms who offer services to clients in finance and in the City of London more generally.<sup>6</sup>

#### Growth in the housing market

Structural problems in the housing market are a potential threat to the economic recovery.<sup>7</sup> More people are buying and selling houses, with the number of residential property transactions nearly 30 percent higher than a year ago.<sup>8</sup> However many commentators are already worried about the sustainability of this, and about the difference in prices between London and other regions of England and Wales.<sup>9</sup>

With higher levels of property transactions, we are aware of the potential for increased cases of mortgage fraud and encourage firms to look for warning signs of this in transactions they are involved in. Some firms may also face skills shortages as they attempt to expand rapidly to meet increased levels of demand.

#### Interest rates

Availability of credit and finance for investment has been an ongoing challenge for law firms. With economic growth and more people in work, an increase in interest rates is becoming more likely.<sup>10</sup> When this takes place will depend on how the wider economy continues to perform. Higher interest rates may limit firms' ability to borrow, but it will also have a positive affect on the amount of interest earned on money held in bank accounts.

4. [Economic Review](#), Office for National Statistics, May 2014

5. [Firms report pre-recession rates of growth](#), The Law Society Gazette, May 2014

6. [Economic Review](#), Office for National Statistics, May 2014

7. [Bank of England's Mark Carney warns on housing market](#), BBC News, May 2014

8. [UK Property Transaction Statistics](#), HM Revenue and Customs, 2014

9. [Housing bubble forming in London, warns Ernst and Young](#), BBC News, 2014

10. [When will interest rates rise? Will the Bank of England raise rates early to cool the property market?](#),

This is money, 2014

## Law as a global business with international clients

Law is a global business and many firms have branches and clients based overseas. International business would not be possible without law firms and lawyers crossing geographical boundaries.

However, we are aware that international work can present its own risks. For example firms may be more at risk of money laundering if they are operating in countries where there is less scrutiny over transactions.

There are other issues such as verifying identity, understanding the law in multiple countries and making sure employees are competent, that may create risks international law firms have to manage.

We have aimed to make our approach as simple as possible for firms we regulate that are delivering legal services in other jurisdictions. In addition to compliance with the local regulations of the jurisdiction where they are delivering legal services, we only require that firms act in accordance with our ten overarching professional principles.<sup>11</sup>

## Market and firm level drivers

There are many significant changes happening in the way law firms operate. This will change the shape of the legal services sector and the way it meets the needs of consumers.

### Financial difficulty

Financial difficulty matters to us because we find it is an underlying cause of many significant risks to the public interest.<sup>12</sup> For instance, financial difficulty can lead to disorderly firm closures. When this occurs the interests of consumers are put at risk. Financial difficulty is often an underlying issue in firms where we encounter misuse of money or assets.<sup>13</sup> We also find it can predicate other key risks, including money laundering and poor standards of service.

Principle 8 requires those we regulate to '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'.

11. [Overseas practice rules 2013](#), Solicitors Regulation Authority, 2013

12. Hence the re-positioning of this issue as a driver of risk in the Risk Outlook 2014/15 (as opposed to including it in Part B, as we did for the Risk Outlook 2013)

13. [Steering the course: Research into the characteristics and risks associated with law firms in financial difficulty](#), Solicitors Regulation Authority, 2014

Over the last year, our engagement with firms has highlighted a range of poor practices associated with firms in financial difficulty,<sup>14</sup> including:

- inability to measure or control financial performance
- autocratic senior partners or managers
- a lack of transparency about financial performance at appropriate levels of management
- excessive borrowing and debt
- excessive partner drawings and remuneration in relation to profit and revenue
- inappropriate use of client account
- weak process for collecting on bills for completed work
- inadequate planning and due diligence in connection with diversification of legal practice or acquisitions of other firms.

The factors listed above include issues relating to levels of competence, ineffective systems and controls, and integrity. We have identified these problems in large corporate firms as well as small businesses.

The improvements in the wider economy do not mean financial difficulty will no longer be a problem. There are also risks associated with firms attempting to expand too quickly in an economic recovery. We have seen firms increasingly making lateral hires to expand the services they can offer. There has been mixed success with this approach, with many lateral hires failing to deliver their intended benefits.<sup>15</sup>

### A consolidating legal market

The key features of a consolidating market include small firms growing, merging or exiting the market, while larger firms are becoming more prevalent. There is evidence the legal services sector is consolidating, and this process is likely to be part of a long-term trend:<sup>16</sup>

- in 2006 sole practitioners made up 41 percent of the profession; in 2013 this had reduced to 29 percent
- there were 60 percent more law firm mergers in 2012 than in 2008
- the market share of the top ten conveyancing firms increased from five percent in 2010 to ten percent in 2012.<sup>17</sup>

14. [Navigating stormy seas](#), Solicitors Regulation Authority, 2014

15. [Lateral partner moves](#) – Year III, Motive Legal, 2013

16. [Magnetic forces, consolidation in the legal services market](#), Solicitors Regulation Authority, 2014

17. [Magnetic forces, consolidation in the legal services market](#), Solicitors Regulation Authority, 2014

When a market is going through a period of change, it is important for firms to be alert to the possible impact it could have on their business. Many firms that we engaged with on grounds of financial difficulty had failed to adapt to changes in the markets they operate in.

Market consolidation may also drive other types of risk, including:

- group contagion, as larger structures form in the legal services sector
- structural instability, if mergers between firms are not subject to adequate due diligence
- conflicts of interest, which is sometimes a risk when firms merge or supply chains converge
- inadequate systems and controls, as firms grow rapidly.

A consolidated market may also bring about opportunities and benefits. For example, the new market structure may provide broader access to legal services.

### Group contagion

We are seeing more firms that are part of a group or conglomerate business structure. A reputational or financial impact in one part of a group can have an impact on the other parts, including those that deliver legal services. This becomes a regulatory matter when it leads to:

- damage to public confidence in legal services
- disorderly closure
- other harm to consumers.

Last year we published a paper on group contagion to highlight this risk to relevant firms.<sup>18</sup>

### Weaknesses in exit planning

In 2013 we received 176 reports about firms that may have been abandoned, meaning they had closed without telling clients or us. This is an increase on 2012, when we had 120 reports.<sup>19</sup> These reports are usually from clients who are not getting a response when trying to contact their firm. They are worried about what will happen to their case if the firm has closed.

The reason behind many abandonments is a failure to plan for what will happen if the firm has to close or be sold. We are likely to see this risk increase as more solicitors reach retirement age but do not plan for the sale or closure of their firm.<sup>20</sup>

This risk can be reduced by planning in advance. Although there are many challenges when selling a law firm, it will help when there are clear business plans in place. We are consulting on changes to run-off insurance requirements, which will assist firms' exit planning.<sup>21</sup>

### A changing professional indemnity insurance (PII) market

In October 2013, we made changes to our PII rules, which included closing the assigned risks pool (ARP) and removing fixed renewal dates.<sup>22</sup> There have been further changes in the market, including the number of participating insurance providers and the type of firms some providers are willing to insure.<sup>23</sup>

18. [Catching a chill, law firms and the risk of group contagion](#), Solicitors Regulation Authority, 2013

19. SRA data

20. [Diversity monitoring statistics 2012](#), Solicitors Regulation Authority, 2013

21. [Consultation discussion paper – Proportionate regulation: changes to minimum compulsory professional indemnity cover](#), Solicitors Regulation Authority, 2014

22. [Professional Indemnity: Summary of changes in effect from 1 October 2013](#), Solicitors Regulation Authority, 2013

23. [Practice note: Professional indemnity insurance, 5. State of the market](#), Law Society, 2013

The insurance market can create a challenging environment for firms to operate in. It is important that firms plan for insurance costs and notify us as soon as possible if they do not obtain insurance. If firms are at risk of not obtaining insurance, an exit strategy should be in place to manage this scenario.

We have recently decided against allowing only 'rated' insurers to provide law firm indemnity insurance, as, although it would provide consistent protection, it might have reduced the availability of affordable policies to smaller firms.<sup>24</sup> Instead, we are consulting on a proposal to reduce the minimum level of cover and the amount of run-off cover, giving firms the responsibility of assessing whether they require further cover.<sup>25</sup> Firms should consider the risks associated with purchasing insurance from 'unrated' providers, particularly in relation to their viability if their insurer withdraws from the market.

### Increased variety of business structures

Prior to 2007, we predominantly regulated solicitors and traditional solicitor firms, and solicitors either practised in those SRA regulated firms or as employed solicitors delivering services to their employers ('in-house' solicitors).

Since October 2011, non-solicitors have been able to own law firms outright. These firms are called alternative business structures (ABSs). This change was introduced to encourage a wider variety of law firms and legal services. This was intended to benefit the public by increasing choice.

As of May 2014, we had licensed nearly 300 ABSs.<sup>26</sup> This is still a relatively small number but it will continue to grow. It is difficult to make general statements about ABSs, as they are such a diverse group of firms. However, there are indications they are using their ABS status to attract investment and make greater use of technology and different approaches to marketing.<sup>27</sup>

Other new structures have also emerged. These include groups of practices working together on collective marketing, online legal services, and solicitors working in partnership with other professionals such as accountants.

There is also an increasing diversity of structure in the wider legal services sector. Examples of this include barristers working directly with clients and legal professionals choosing to work outside the reserved activities in areas like alternative dispute resolution.

We have also highlighted that there are a relatively small number of firms operating as Multi Disciplinary Practices (MDPs).<sup>28</sup> This could be potentially significant as MDPs could provide 'one-stop shop' type practices which could meet the needs of consumers that currently do not access legal services. This year we are consulting on ways to remove unnecessary regulatory barriers that might be restricting the number of MDPs in the legal services sector.<sup>29</sup>

24. [Introduction of a minimum financial strength rating requirement for Participating Insurers](#), Solicitors Regulation Authority, 2014

25. [Consultation discussion paper – Proportionate regulation: changes to minimum compulsory professional indemnity cover](#), Solicitors Regulation Authority, 2014

26. [Register of licensed bodies \(ABS\)](#), Solicitors Regulation Authority, as of May 2014

27. [Research on alternative business structures](#), Solicitors Regulation Authority and ICF GHK Consulting, May 2014

28. [SRA takes new look at MDPs](#), Solicitors Regulation Authority, 2014

29. [Consultation discussion paper: Multi-disciplinary practices](#), Solicitors Regulation Authority, 2014

## Fixed fees

Research has shown consumers prefer to pay a fixed fee for their legal work, rather than paying hourly rates.<sup>30</sup> Law firms are already responding to this and many house buyers and sellers, and people wanting to make a will, are already paying fixed fees.<sup>31</sup> This trend may bring benefits to consumers and encourage more people to use legal services. It may also pose challenges for law firms as they adapt to meet consumer expectations, particularly in more complex areas of law where it can be more difficult to estimate costs accurately.

## Political and regulatory changes

Changes in legislation and regulation have an impact on the development of the legal services sector.

### Political changes

#### Criminal Legal Aid reform

The Ministry of Justice has confirmed details of changes to criminal legal aid, including significant reductions in rates and a reduction in the number of firms providing criminal legal aid by two thirds.<sup>32</sup> The Ministry of Justice has also set out the ways in which firms can make collective bids for contracts.<sup>33</sup>

Other changes in this market include a background of falling reported crime, reduced use of the courts through better case management and incentives to plead early. This may lead to some legal aid firms merging or leaving the market.<sup>34</sup>

#### Personal injury and embedding the ban on referral fees

The Government's decision to reduce the fixed recoverable costs and ban referral fees in personal injury cases has increased the cost pressures on personal injury firms. Other proposed changes include the creation of medical referral panels for whiplash injury cases.<sup>35</sup> Diversification can be a particular challenge for personal injury firms because of the specialist skills required in different areas of this market.

#### LLP tax changes

Many law firms are structured as limited liability partnerships (LLPs). The introduction of new tax rules mean some LLP members, who were formerly treated for tax purposes as self-employed, are now taxed as employees.<sup>36</sup> Reports to date indicate that this will present a significant challenge to the financial management of some firms.<sup>37</sup>

30. [Cost of services: Consumer preference for fixed fees](#), Legal Services Board, 2014

31. [Cost of services: Consumer preference for fixed fees](#), Legal Services Board, 2014

32. [Transforming Legal Aid: Next Steps](#), Ministry of Justice, 2014

33. [Transforming Legal Aid: Next Steps](#), Ministry of Justice, 2014

34. [Transforming legal aid: delivering a more credible and efficient system – Consultation Paper](#), Ministry of Justice, 2013; [Reduction in sentence for a guilty plea](#), Home Affairs Committee, 2013; [Independent criminal advocacy in England and Wales: A review by Sir Bill Jeffrey](#), Ministry of Justice, 2014

35. [Personal injury claims](#), Ministry of Justice, 2014

36. [Consultation outcome: A review of two aspects of the tax rules on partnerships](#), HM Revenue and Customs, 2014

37. [Tax code breakers](#), The Lawyer, April 2014

## Consumer credit licensing

From April 2014, legal businesses that conduct consumer credit activities could no longer use the group credit licence, which ended that month. The majority will now need to be licensed directly by the Financial Conduct Authority (FCA).<sup>38</sup> As part of the transfer of regulation of consumer credit activities to the FCA, transitional arrangements were put in place for firms affected by the changes until 30 September 2014. Following discussions with the FCA, the SRA has secured agreement to extend these transitional arrangements for consumer credit up until 1 April 2015. The extension provides us the opportunity to continue to work with the FCA in relation to the rules that will apply to SRA regulated firms. We have published information and a 'questions and answers document' on our website to assist firms.<sup>39</sup>

## Court enforcement of procedural rules

Firms acting in litigation need to be aware of the stricter attitude of the Courts towards failure to comply with directions following the ruling of the Court of Appeal in the Mitchell case.<sup>40</sup> The Courts will prioritise the public interest in the proper administration of justice over hardship in individual cases, with solicitors in the Mitchell case being limited to recovering court fees alone for failing to submit a costs figure seven days before the hearing. Firms may face a financial impact if they fail to comply with court instructions or orders.

## Regulatory changes

### Reducing regulatory burdens

We are implementing a programme of regulatory reform to become a more proportionate regulator

that balances the need to protect the public interest against ensuring solicitors can fulfil their obligations in the proper administration of justice.<sup>41</sup>

Our work includes:

- removal of unnecessary regulatory barriers and restrictions to enable increased competition, innovation and growth to serve better the consumers of legal services
- reduction of regulatory burdens and costs on regulated firms
- ensuring regulation is properly targeted and proportionate for all solicitors and regulated businesses, particularly smaller businesses.

The initial stages of this work include:

- changes to enable increased entry of MDPs to the market and to ensure our regulation of these firms is targeted and proportionate
- changes to the arrangements for compulsory PII to ensure the minimum requirements set for firms are proportionate, while maintaining appropriate public protections
- changes to the compensation arrangements to ensure these are targeted at consumers requiring protection, and to ensure the overall cost is proportionate and affordable
- changes to the requirements for accountants' reports on client accounts to reduce the cost of the current arrangements, while maintaining proportionate safeguards over client money.

38. [Detailed rules for the FCA regime for consumer credit](#), Financial Conduct Authority, 2014

39. [Regulation of consumer credit: Q&A](#), Solicitors Regulation Authority, 2014

40. [Approved judgement](#), in the Court of Appeal (Civil Division) on appeal from the High Court, Queen's Bench Division Master McCloud HQ13D01052, Mitchell v News Group Newspapers, 2013

41. [SRA announces major programme of regulatory reform](#), Solicitors Regulation Authority, May 2014

## Training for Tomorrow

2013 saw the publication of the Legal Education and Training Review (LETR), an extensive piece of research into the fitness for purpose of the education and training requirements of the legal profession.<sup>42</sup> The report found there were changes required to improve legal education and training, and as a result we launched our reform programme 'Training for Tomorrow'.

'Training for Tomorrow' has three main elements: an effective competence framework, continuing competence, and a new regulatory framework. These reforms will provide greater freedom for law firms, but ensure a continued focus on competence.<sup>43</sup>

### Poor or missing regulatory information

To allow us to be targeted and proportionate, we require data and information from those we regulate. Most of this is collected annually, but we also require firms to report important regulatory matters to us when they identify them. In addition to this, we may request information about a particular issue, such as financial stability.

This information helps us direct resources to areas of greatest risk. However, not all firms comply with these requirements. We have seen failure to cooperate or comply in a number of cases:

- unreported firm closures (or abandonments)
- unreported failure to obtain insurance (and cases where firms have provided false or misleading information to insurers when obtaining a new policy)
- failure to undertake diversity data collection
- failure to cooperate with the legal ombudsman.

In severe cases there are issues of ethics and integrity at non-compliant firms. In other cases mistrust and misunderstanding may lead to a reluctance to comply with information sharing requirements.

We continue to take enforcement action where firms remain uncooperative and fail to engage with us, particularly where clients are put at risk by abandoned or uninsured firms. In addition, we are continuing to review how much information we collect, with the aim of reducing burdens on firms where the regulatory benefits of collecting the information are not clear.

42. [LETR website](#)

43. [Training for Tomorrow](#), Solicitors Regulation Authority, 2014

## Consumer behaviour and expectations

### Unmet need for legal services

There are many ways consumer behaviour and expectations affect risk in the legal services sector. For example, we discussed in the Risk Outlook 2013 how some consumers do not seek help as they believe legal services to be prohibitively expensive, which is a risk to access to justice.<sup>44</sup>

Research has shown that less than one in three people with a civil or social justice problem seek professional advice, and of these, less than half seek advice from a solicitor.<sup>45</sup>

The latest research for by Legal Services Board suggests that just under one in ten people seeks help from a lawyer, even when they have a legal problem they class as 'severe'.<sup>46</sup>

### Vulnerability

Potentially all clients are vulnerable, but there are some clear factors that increase the risk. One of the main causes of vulnerability is arguably the difference in the ability of the professional solicitor and their clients to understand complex legal work. In many cases consumers are not able to judge the quality of legal services or a price that represents good value for money.

Other factors that can drive an increased risk of vulnerability include situations where clients face a greater impact if things go wrong, situations where clients are distressed or when access to redress is limited.<sup>47</sup>



44. [Research Note: the Legal Services Market](#), Legal Services Board, 2011

45. [Civil Justice in England and Wales: Report of Wave 1 of the English and Welsh Civil and Social Justice Panel Survey 2010](#), Legal Services Research Centre, 2011

46. [How people resolve 'legal' problems](#), Professor Pascoe Pleasence and Dr. Nigel J. Balmer for the Legal Services Board, 2014

47. As outlined in Cartwright, P. [The Vulnerable Consumer of Financial Services: Law, Policy and Regulation](#)



## Part B: Key risks

This section sets out the key risks to the regulatory objectives. We have grouped these risks into two categories:

**Current priority risks:** we have evidence these risks are widespread, current, and pose a significant risk to the public interest.

**Other priority risks:** these are priority risks, but they are not as widespread in the legal services sector, or there are evidence gaps which mean we cannot be as certain about the full extent of these risks.<sup>48</sup>

Our Risk Index sets out the full range of risks to the regulatory objectives.<sup>49</sup> The Risk Outlook sets out our priorities, but it is important that law firms ensure they are managing the risks most relevant to their business and clients.



### Current priority risks

The following risks are categorised as 'current priority'

- Misuse of money or assets
- Money laundering: inadequate systems and controls over the transfer of money
- Bogus firms
- Lack of diverse and representative profession
- Failure to provide a proper standard of service: quality of legal services to vulnerable consumers.

### Misuse of money or assets

We are particularly concerned when client money or assets are put at risk. This can happen as a result of:

- dishonesty
- poor systems and controls, particularly in relation to client accounts
- a lack of competence, resulting from insufficient training or understanding.

#### ⊖ Negative effects

Misuse of money and assets is not only a direct risk to clients. It is also a threat to public confidence in legal services. A loss of public confidence in law firms could have an impact on access to justice and the overall standing of the provision of legal services in England and Wales.

48. This categorisation simplifies the 'current', 'emerging' and 'potential' groupings used in the Risk Outlook 2013. We found that the previous system did not accurately reflect the nature of the risks we face

49. [Risk Index](#), Solicitors Regulation Authority, 2014

**Trends**

In 2013 we reported an increase in the number of cases of misuse of money or assets that we were dealing with. This trend, set out in the table below, remains a concern. Financial difficulty and poor financial management in firms has been one of the underlying causes of this trend.<sup>50</sup>

Typically, the grounds for around 30 percent of interventions involve suspected dishonesty and nearly half include accounts rules breaches. Over the last year, there were 19 interventions made on the grounds of suspected dishonesty, out of a total of 51.<sup>52</sup>

This issue can be found across a wide range of firms. In larger firms, the issue usually arises as a result of systems and controls failing to detect a rogue individual or group of individuals misusing money. We have found that for small and medium firms, this risk is more common if a firm is in

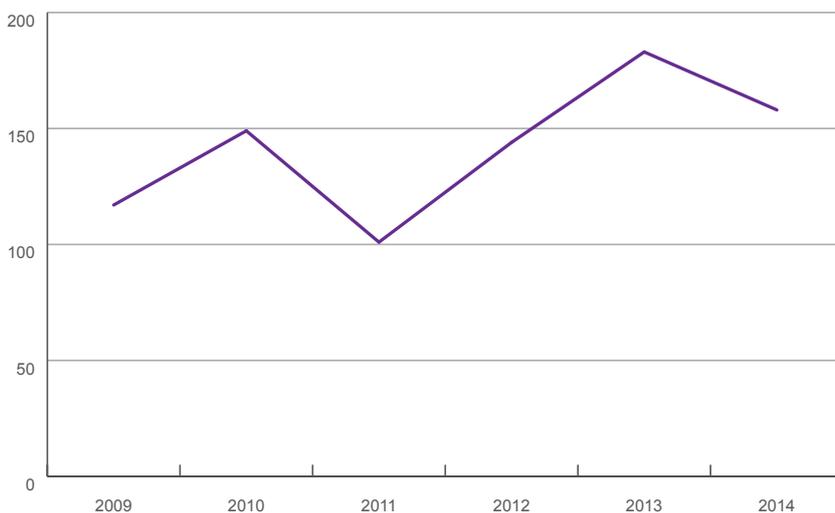
financial difficulty, when money is sometimes misused to try and prevent the firm from failing.<sup>53</sup>

**SRA controls**

We place professional obligations of integrity on those we regulate. These are articulated through:

- **Principle 2** – ‘act with integrity’
- **Principle 6** – ‘behave in a way that maintains the trust the public places in you and the provision of legal services’
- **Principle 10** – ‘protect client money and assets’.

We have a number of controls that apply directly to this risk. The way we supervise those we regulate helps us to identify firms where this risk is greatest. We also treat reports of misuse of client money as urgent matters when they are brought to our attention.



**Matters reported: misuse of money or assets (monthly average)<sup>51</sup>**

50. [Steering the course: Research into the characteristics and risk associated with law firms in financial difficulty](#), Solicitors Regulation Authority, 2014

51. SRA data: matters reported (2014 average based on Jan-April data only). Please note, the data provided on this topic for 2013 was for ‘dishonest misuse of client money and assets’ only. The chart above shows all misuse of money and assets, including instances where dishonesty was not found.

52. SRA data for period June 2013 to May 2014

53. [Navigating stormy seas: Financial difficulty in law firms](#), Solicitors Regulation Authority, 2013

We have a whistle blowing policy and a 'Red Alert' hotline which allows us to take immediate action when this risk materialises.<sup>54</sup>

The Compensation Fund provides redress for consumers who suffer financial loss due to dishonesty or a failure to account. However, we generally take a proactive approach to reduce instances of this type of consumer detriment occurring.

Our work on financial difficulty has brought more cases of misuse of client money to light, in some cases earlier than would have been achieved without this work. This has led to better consumer protection.



Contact our Red Alert line on

**0345 850 0999**

or email [redalert@sra.org.uk](mailto:redalert@sra.org.uk)

## Case study 1:

### Misuse of client money at a firm with financial problems

Mr Green had practised as a sole practitioner for about 25 years, specialising in probate work. He was struck off the roll of solicitors because he misused client money in an attempt to improve the finances of his firm.

In many of the cases he dealt with, there was a considerable length of time between the date the work began, and the date when a final bill could be presented to the client. This started to create serious cash flow problems for his firm during the economic downturn, which increased when his bank refused to extend his firm's office account overdraft.

In an effort to increase cash flow, Mr Green started estimating the final costs he thought he would charge in each case and producing 'interim' bills at the outset of each matter. Whenever the firm's cash flow was particularly tight or the overdraft limit in danger of being exceeded, he withdrew the amounts in these 'interim' bills from the client account, without having actually completed the work or notifying

his clients. He explained that he felt this was not contrary to the SRA Accounts Rules, as long as the work was later completed and the client notified of the actual costs charged in their final bill.

We disagreed and carried out an investigation in which we found a client account shortfall of approximately half a million pounds. Further investigation revealed several probate matters where the interim charges taken from client account did not reflect the final costs. In one case, a client had been billed more than twice the actual cost of the matter. In another, the fees charged amounted to over half the value of the estate.

As a result of our findings and the continued shortage of client money, we intervened into the firm due to the significant risk to clients. Mr Green was then referred to the Solicitors Disciplinary Tribunal where he was found to have acted dishonestly. He was struck off the roll of solicitors and ordered to pay costs.

54. [Whistle blowing to the SRA](#), Solicitors Regulation Authority, 2012

## Money laundering: inadequate systems and controls over the transfer of money

Law firms can handle large sums of money and can make attractive targets for those wishing to launder the proceeds of crime or otherwise disguise improper transfers of money. This risk includes:

- intentional money laundering
- money laundering that is facilitated by inadequate systems and controls
- failure to comply with statutory anti-money laundering obligations.

Money laundering is not a new risk for law firms. However, the techniques used and the context in which it takes place are constantly changing and becoming ever more sophisticated.

We have also seen cases where firms have used their client account to offer a banking facility to clients where there was no underlying legal transaction to necessitate this. The Courts have agreed with us that it is not part of a solicitor's proper function to provide a banking facility in these circumstances. The risk is compounded if the client account is being used to evade insolvency legislation.

### ➊ Negative effects

Money laundering is a serious crime and a priority for governments, both in the UK and internationally. Preventing money laundering is clearly in the public interest.

### 📊 Trends

Managing this risk has increased in importance from 2013, when our Risk Outlook assessed it as an 'emerging risk'. More people have been reporting suspected money laundering through law firms and we are investigating several serious cases.<sup>55</sup>

Between October 2012 and September 2013, solicitors made 3,615 suspicious activity reports (SARs) to the National Crime Agency (NCA), 1.1 percent of all reported SARs. The majority of these were consent SARs, where a professional seeks consent to continue with a transaction.<sup>56</sup> An NCA analysis of these reports found a high proportion received from the legal sector were of poor quality. Many did not contain enough information about the suspicious activity for the NCA to be able to make a decision about whether the transaction should go ahead.<sup>57</sup>

Money laundering and inadequate systems and controls are risks affecting a wide range of law firms. The following text box explains how they have occurred in different areas of the legal services sector.

55. [Risk Outlook 2013/2014: Spring 2014 update](#), Solicitors Regulation Authority, 2014

56. [Suspicious Activity Reports \(SARs\) Annual Report 2013](#), National Crime Agency, 2013

57. United Kingdom Financial Intelligence Unit guidance note: A review of legal sector consent requests, National Crime Agency, 2014

### Issues affecting large corporate firms with commercial clients.

- clients could have significant political connections<sup>58</sup> or connections to organised crime. These types of clients will often not approach a firm directly, but launder money through an intermediary business or contact.
- we have seen recent cases where law firms have been profiting from offering banking facilities over and above those required for legal work. This may indicate money laundering and is not permitted under the SRA Accounts Rules.

### Issues affecting small and medium-sized firms, particularly those who do conveyancing.

- a client failing to provide valid identity documents is one of the key money laundering flags.<sup>59</sup>
- when speaking to 100 randomly selected conveyancing firms in 2012, we found one in four had experienced cases of attempted money laundering. The majority of which were identified through attempts to avoid or cheat identity checks.<sup>60</sup>

### SRA controls

It is rare to be able to establish that a law firm has intentionally laundered money unless there has been a full investigation with other agencies using their specific powers and access to intelligence. Therefore, we focus on ensuring that firms have systems and controls in place to make money laundering difficult.

To have anti-money laundering controls is a legal obligation, not just a regulatory requirement. Firms are required by law to:<sup>61</sup>

- have a nominated money laundering reporting officer (MLRO)
- report any suspicious activity they think may indicate money laundering to the NCA, and have a process setting out how they do this
- verify the identity of clients, beneficial owners and the nature of business transactions and keep records of these checks.

We deal with reports of money laundering urgently and have a specialist working group to keep up to date with relevant issues. We are currently looking at the problem of poor quality SARs from law firms as part of a specific focus on anti-money laundering activity.<sup>62</sup>

58. Referred to in legislation as 'Politically Exposed Persons' (PEPs)

59. [Money Laundering and Terrorist Financing Vulnerabilities of Legal Professionals](#), Financial Action Task Force, 2013

60. [Conveyancing thematic study: Full report](#), Solicitors Regulation Authority, 2013

61. [The Money Laundering Regulations 2007](#), HM Treasury, 2007, [Terrorism Act 2000 and Proceeds of Crime Act 2002 \(Amendment\) Regulations 2007, Home Office, 2007](#). Please note this is a simplified overview. For more detailed information about legal obligations of law firms, consult the Law Society's [Anti-money laundering practice note](#).

62. United Kingdom Financial Intelligence Unit guidance note: A review of legal sector consent requests, National Crime Agency, 2014

## Case study 2:

### Failure to detect money laundering

Mr White was a solicitor at XYZ Law when Mr Grey instructed him in the purchase of a residential property. Mr White had acted for Mr Grey on a number of other matters in the past.

Mr Grey owned a chain of shops, and he said he would be using the profits from this business to pay for the property. Mr White asked Mr Grey to provide evidence of this, and he presented a letter from a high street bank showing that he had been their customer for several years, along with a statement which showed the yearly income from the shops.

A short time later, Mr Grey contacted Mr White to say that he was being held in police custody. Mr White asked if his arrest was in any way related to the property purchase or his business interests but Mr Grey confirmed it was not, and said that his brother would verify this. Mr White did no further checks into the reasons for the criminal investigation.

After Mr Grey was released from custody, he transferred £225,000 into XYZ's client account to buy the property. The monies in fact came

from a third party's overseas bank account. Mr Grey explained to Mr White that the funds were a loan from his uncle. He supplied a letter from the uncle as evidence of this. Mr White did not take any steps to check this or the uncle's identity and continued to act on the property purchase.

It later emerged that Mr Grey had been held in custody over serious drug-related charges and, unknown to Mr White, had bought the property to launder money from his illegal drug business.

Mr White admitted that with hindsight he should have suspected money laundering, but said that he failed to detect it because he had relied on his client. The SRA Adjudicator decided that he should have made further enquiries and should have reported concerns about potential money laundering. The Adjudicator ordered that Mr White should pay a fine and costs as well as undertake further training on money laundering avoidance.

## Case study 3:

### Inappropriate use of a client account

Ms Brown was a long standing and valued client of PQR LLP. She told Mr Gold, a senior partner at PQR, that she needed to pay some creditors of her business, a high profile export company, and asked for his help.

Ms Brown revealed to Mr Gold that her business was in severe financial trouble and her bank was considering appointing an administrator. She asked if she could temporarily use PQR's client account to pay her creditors, rather than face the possibility of decisions about who to pay being made by the administrators if the worst happened.

As Ms Brown had always used PQR to manage both her business and personal affairs, Mr Gold agreed she could use the client account in this way for a small fee. He told her he was very sympathetic about her financial problems and to the creditors to whom she owed money, some of whom his firm had done work for in the past.

Over a four month period, Ms Brown transferred just over £2.2m into PQR's client account. At different times, Mr Gold and three of his colleagues authorised payments directed

by Ms Brown from the funds held, including paying off shareholder loans and some key trade creditors. After about two months, administrators were appointed to administer Ms Brown's company but the firm continued to make the payments, until all the funds were used.

We received a number of complaints from unpaid creditors about the position. An inspection of PQR's accounts quickly revealed these payments and the improper use of the firm's client account. No legal work was undertaken by the firm in relation to the matter. Mr Gold and the firm were brought before the Solicitors Disciplinary Tribunal.

Mr Gold was fined £30,000 plus costs, and the firm a lesser amount. Creditors who might otherwise have received money owed to them by Ms Brown are still out of pocket. The Administrators of Ms Brown's company are considering taking legal action to recover monies paid out through the client account.

## Bogus firms

The term 'bogus firm' is used to describe situations where criminals take on the identity of a law firm in order to steal money or access information. Law firms are often targeted as they can make these scams look more legitimate.

Some bogus firms target consumers directly. These cases often involve criminals aiming to entice a consumer to engage with the bogus firm as if it were a genuine law firm. Other bogus firms target genuine law firms. For example, this might involve setting up a false conveyancing transaction.

### ⊖ Negative effects

Bogus firms are a risk to consumers losing both money and confidential information. There is also a risk their existence will lead to a lack of public confidence in legal services or deter members of

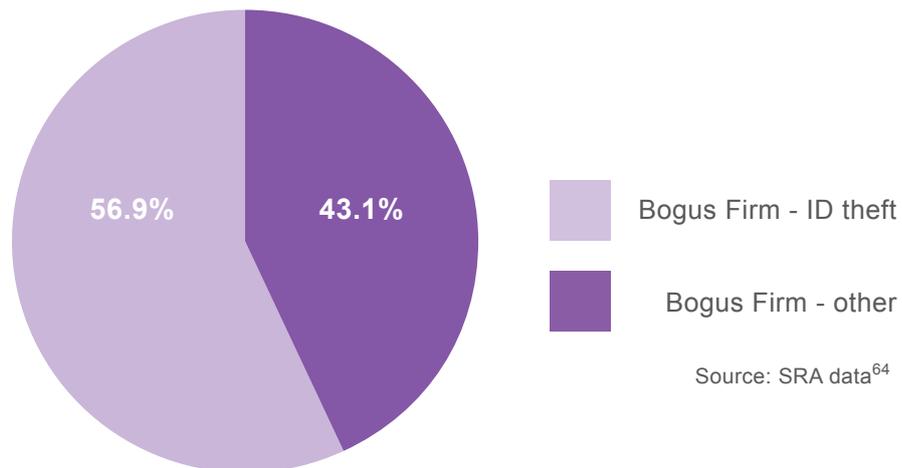
the public from seeking advice from law firms. Law firms will also want to manage the risk of bogus firms due to the direct harm they can cause to their business in terms of reputational or financial damage.

### ▮ Trends

We are seeing an increasing number of these cases. In 2013 we received 548 reports about bogus firms, a 57 percent increase on 2012.<sup>63</sup> We have already received 235 reports about bogus firms in the first four months of 2014.

The majority of bogus firm reports relate to situations where the identity of an existing firm has been used. We have seen examples of this in relation to both small firms and large corporations.

The following chart shows that over half of the bogus firm reports we received in the first four months of 2014 involved the use of the identity of an existing firm or individual.



Reports to the SRA of bogus firms or individuals, January – April 2014

63. SRA data

64. Source: SRA data. 'Other' bogus firms include cases where fraudsters have invented a fictitious firm or individual

### SRA controls

We cannot remove the risk of bogus firms by ourselves, but we can raise awareness through issuing urgent alerts on our website when these matters are brought to our attention. We have also encouraged firms to take steps to protect their identities.<sup>65</sup> Since the start of 2014 we have issued 90 alerts relating to bogus firms and scams.<sup>66</sup>



Contact our Red Alert line on  
**0345 850 0999**  
or email [redalert@sra.org.uk](mailto:redalert@sra.org.uk)

The good practices we encourage law firms to carry out to reduce this risk include:

- regular internet searches of the firm name to check for identity theft
- checking the firm on the Law Society's 'Find a Solicitor' to ensure details are correct
- being alert to suspicious incidents, such as when others seem to think your firm is dealing with a transaction you are not aware of
- regularly checking our website for scam alerts
- contacting our 'Red Alert' hotline if you believe someone has stolen the identity of your firm or anyone working within it.<sup>67</sup>



65. [Warning notice: Bogus firms and identity theft](#), Solicitors Regulation Authority, 2012

66. Between 1 January 2014 and 12 June 2014

67. The SRA's Red Alert Line is 0345 850 0999, or email [redalert@sra.org.uk](mailto:redalert@sra.org.uk)

## Case study 4:

### Non-solicitor sets up bogus office to steal money

Mr and Mrs Black instructed JKL Solicitors to help them buy a house. Soon JKL received a phone call about the sale from the sellers' solicitor Mr Red.

JKL checked the Law Society's website, which appeared to confirm that Mr Red was a qualified solicitor at a genuine law firm called MNO Solicitors.

The house purchase proceeded normally. Mr and Mrs Black signed the contracts and arranged with their bank for the £200,000 mortgage loan to be sent to JKL, who then transferred it to MNO Solicitors on completion. A few days later, JKL attempted to register Mr and Mrs Black as the new owners of the house.

However, it was then revealed that the house already had an owner – the seller who Mr Red had claimed to represent. This individual had not sold his house to Mr and Mrs Black; he was still living in it, was still making mortgage payments, and in fact had never heard of Mr Red.

Investigations revealed that a fraudster had used Mr Red's identity to set up a fake branch office of MNO Solicitors using forged notepaper. He had stolen the mortgage advance and then disappeared, leaving no traceable records.

Although the name of a real law firm was used, some key information had been changed, such as the telephone contact number and details of MNO Solicitors' client account. Mr and Mrs Black's lender was left to bear the financial loss of the mortgage advance, and Mr and Mrs Black were left out of pocket and without a house.

Court proceedings followed and JKL were not found to be at fault as they had taken proper steps to check Mr Red's identity, and the fraud had been sophisticated. However, the case had a negative impact on the firm's reputation when the case was reported in the local paper.

## Lack of diverse and representative profession

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Evidence still points to barriers to progression in legal careers for certain demographic groups. In the Risk Outlook 2013 we set out concerns about particular demographics of the legal services workforce by:

- gender
- ethnicity
- socio-economic background.

There are a range of societal factors that contribute to this, such as a lack of information, from an early age, on career options and access to higher education. Nonetheless, more progress is required to achieve a 'strong, diverse and representative' legal profession.

### ➊ Negative effects

The lack of a diverse and representative profession is contrary to the public interest. The Legal Services Act places a duty on us to encourage 'an independent, strong, diverse and representative legal profession'. It is in the public interest for us to fulfil this obligation, as it will contribute to:

- **quality legal services** – by reducing barriers to entry and retention, legal services will be provided by the best and brightest professionals available. This applies to legal services as a whole, but also to sectors within it. Corporate work done by large firms is delivered by a less diverse workforce than many other areas of law. 61 percent of black, Asian and minority ethnic individuals we regulate work as sole practitioners or in firms with between two and four partners. Only ten percent are in firms with more than 81 partners.<sup>68</sup>
- **administration of justice** – legal services enable the proper administration of justice and the rule of law. The legal profession that undertakes this important role in society should reflect the demographics of the population it serves. For example, just under one third (31 percent) of those in partner or equivalent roles attended an independent/fee paying school, a far higher proportion than in the general population. More than twice as many men as women hold these senior roles from which we select our judiciary; 69 percent of partners or equivalent are male.<sup>69</sup>
- **access to justice** – some people may not choose to seek professional legal advice if they do not feel they share any social or cultural characteristics with those that work in legal services.

These factors give us a stronger rationale for focusing on diversity compared with regulators of other industries.

68. [Diversity in the legal profession: Workforce data for solicitors' firms 2013/14](#), Solicitors Regulation Authority, 2014

69. [Diversity in the legal profession: Workforce data for solicitors' firms 2013/14](#), Solicitors Regulation Authority, 2014

**Trends**

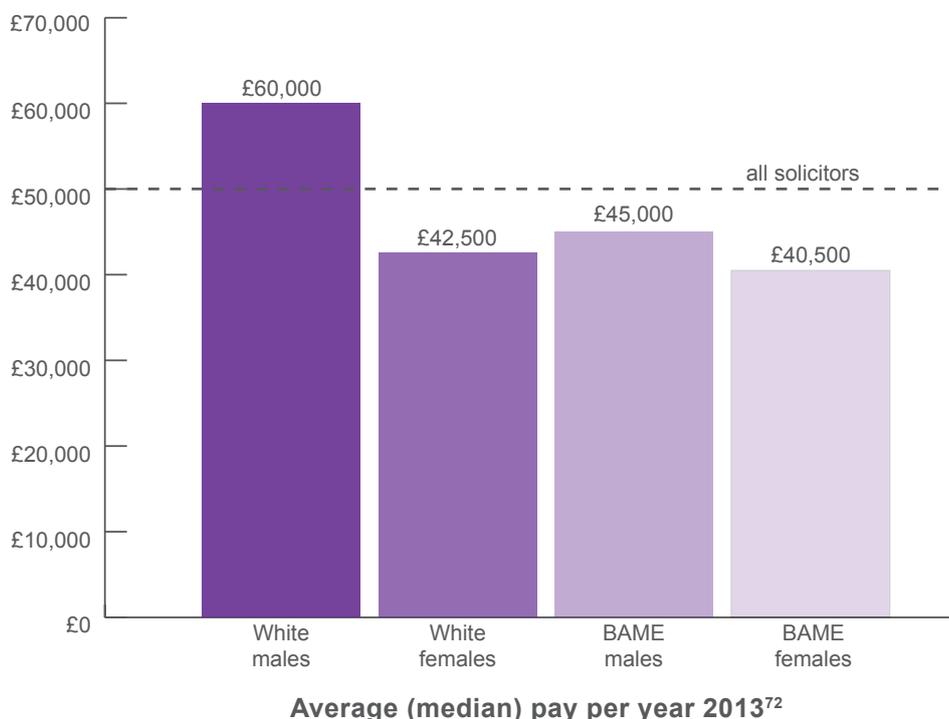
Our diversity data collection has revealed very little change in the makeup of the profession since last year’s survey.<sup>70</sup>

In addition, new evidence has added to our concerns about diversity. The pay gap between male and female solicitors increased in 2013, and is larger (30 percent) than in the general working population (10 percent).

A pay gap is present at all levels of practice between female and male solicitors and between black, Asian and minority ethnic (BAME) solicitors and their white counterparts.<sup>71</sup> Evidence has also

highlighted concerns about barriers to progression for these groups within law firms.

Previous research into diversity in the profession has found few people report overt discrimination while working in the legal sector. However, when researchers interviewed people in a variety of different groups, many reported more subtle discrimination, such as being asked inappropriate questions at interview. Research also indicates there is a reluctance to complain in case this affects workplace progression.<sup>73</sup>



70. [Diversity in the legal profession: Workforce data for solicitors' firms 2013/14](#), Solicitors Regulation Authority, 2014  
 71. [Private practice solicitors' salaries 2013: The Law Society's PC Holder Survey 2013](#), Law Society, 2014  
 72. [Private practice solicitors' salaries 2013: The Law Society's PC Holder Survey 2013](#), Law Society, 2014  
 73. [Diversity in the legal profession in England and Wales: a qualitative study of barriers and individual choices](#), Summerlad et al., 2012

### SRA controls

We view the lack of a diverse and representative profession as a risk that exists at the level of the market as a whole. This means a different type of regulatory response is needed compared with risks that occur directly within the context of a firm, such as money laundering. Our controls, such as collecting workforce diversity data, are designed to influence the behaviour of the entire market and help us track the way it changes.

We require data on the demographics of firms' workforces so we can track market changes and understand whether barriers are faced by specific groups. Firms should use their own diversity data to understand how they compare to the rest of the legal sector, and to help identify areas for improvement. Some firms have already used their own data to identify and target specific issues. For example, a number of large law firms have changed the way they recruit trainees to reduce the influence of their socio-economic background.<sup>74</sup>

We want to work with law firms to encourage a diverse and representative profession which will deliver benefits to consumers and the wider public interest. It is important we make a distinction between this approach to a market level risk and our approach when we identify evidence of discrimination against individuals. Where discrimination is found we will take proportionate enforcement action.

Managing this risk is directly in the interest of law firms as they will also benefit from a more diverse workforce.<sup>75</sup> Diverse management can lead to better corporate decision making and a representative workforce may help attract new clients. If there are reduced barriers to progression and retention of talent, firms will benefit as their services will be delivered by 'the best person for the job'.

### Failure to provide a proper standard of service: quality of legal services to vulnerable consumers

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There is a range of evidence which suggests the standards of service and quality of legal advice sometimes fall below the level that can reasonably be expected by consumers. It is proportionate for us to focus our regulatory resources on the issue of poor quality legal advice when it is more likely to affect clients who are vulnerable.

Vulnerability could exist because some consumers may have limited ability to judge the quality of legal advice they receive. For example, private clients may be more likely to be vulnerable than sophisticated corporate clients with in-house legal expertise.

74. [Mayer Brown set to launch blind CV policy to boost social diversity](#), The Lawyer, 2014 and [Clifford Chance broadens diversity with 'CV blind' scheme](#), Law Society Gazette, 2014

75. [Diversity and inclusion in law firms: the business case](#), Law Society, 2014

Many areas of law can involve situations which could increase the risk of a consumer being more vulnerable. This could occur if consumers are in a stressful situation, for example due to ill health as a result of a personal injury or involvement in a child custody dispute. Vulnerability may also be greater when the effect of an adverse outcome will lead to a greater impact, such as deportation in an asylum case.

### ⊖ Negative effects

When poor quality legal advice is given this may lead to a client receiving an adverse or inappropriate legal outcome. This could involve financial loss or, in more severe circumstances, lead to harm such as loss of access to children, deportation or imprisonment.

A perception of poor legal advice may deter consumers from seeking legal advice in the future, which presents a wider risk to access to justice. If poor quality legal advice is widespread, this will have a negative effect on the proper administration of justice and the rule of law.

### ▮ Trends

Measuring the precise extent of poor quality legal advice is a challenge. Several research projects have highlighted serious concerns about quality. Investigations and case reviews have highlighted situations where clients may have received poor quality advice.

Specific examples of cases where poor quality legal advice has been identified include:

- research on the quality of will writing which found approximately one-quarter of wills either did not meet the needs and circumstances of the client, or were legally invalid<sup>76</sup>
- academic research which found levels of quality were lower among solicitors than non-solicitors for similar types of work; and ‘mystery shopper’ work that showed generalist practitioners were taking on specialist work they were not able to carry out to a sufficient standard of quality<sup>77</sup>
- concerns about quality in criminal advocacy led to the development of the Quality Assurance Scheme for Advocates (QASA). These concerns were recently reiterated in the Jeffrey Review<sup>78</sup>
- a review of the quality of legal advice for asylum seekers which is exploring concerns some asylum clients are not advised of the full range of legal arguments available to them<sup>79</sup>
- several research reports showing certain client groups may receive inadequate levels of service and support when they use a lawyer.<sup>80</sup>

Further research and investigation is required to explore these problems and to assess levels of quality in other areas of law.

76. [Understanding the consumer experience of will writing](#), IFF Research for the Legal Services Board, the Solicitors Regulation Authority, the Legal Services Consumer Panel, and the Office for Fair Trading, 2011

77. R Moorhead et al., *Quality and Cost: Final Report on the Contracting of Civil, Non-Family Advice and Assistance Pilot*, Stationery Office, 2001, and R Moorhead and A Sherr, [An Anatomy of Access: Evaluating Entry, Initial Advice and Signposting Using Model Clients](#), Legal Services Research Centre, 2003, as discussed in R Moorhead, [Precarious Professionalism - Some empirical and behavioural perspectives on lawyers](#), UCL Centre for Ethics and Law, 2014

78. [Independent criminal advocacy in England and Wales: A review by Sir Bill Jeffrey](#), Ministry of Justice, 2014

79. C Hutton and S Lukes – [An interim external evaluation of Refugee Action’s Access to Justice Project](#), Refugee Action, 2013

80. [Legal choices – silent process: engaging legal services when you do not hear](#), The Deaf Studies Trust for the Solicitors Regulation Authority, the Legal Services Consumer Panel and Action on Hearing Loss, 2011; [What happens when people with learning disabilities need advice about the law?](#), the Norah Fry Research Centre and the University of Bristol for the Legal Services Board and the Legal Services Consumer Panel, 2013

Poor standards of service and quality become a greater risk when consumers do not have access to redress. The first point of redress should be a firm's own complaints handling procedures. The Legal Ombudsman has recently published a business case for good complaints handling.<sup>81</sup> Their research has also highlighted concerns about the quality of sign-posting by law firms to the Ombudsman for complaints that are not resolved at the first tier.<sup>82</sup>

### SRA controls

The responsibilities of those we regulate are set out in:

- Principle 4 – 'Act in the best interests of each client'
- Principle 5 – 'Provide a proper standard of service to your clients'.

The Handbook places a responsibility on those we regulate to ensure 'clients are in a position to make informed decisions about the services they need, how their matter will be handled and the options available to them'.<sup>83</sup>

One of the most effective controls we can use is to ensure that a high level of competence is maintained through the training and education of solicitors. An important piece of this work, as explained in Part A, is 'Training for Tomorrow'. This aims to reform legal training and education so lawyers have the required levels of competence when they qualify, and that these skills are adequately updated throughout their careers.

There are many gaps in the evidence base, which prevents us from being able to understand fully problems with quality across all types of legal service. We use research to fill these gaps, particularly targeting areas where concerns have been highlighted.

Poor standard of service and quality of advice is taken seriously in our enforcement action. For example, the standard of service is regularly taken into account when we prosecute cases before the Solicitors Disciplinary Tribunal.

81. [The business case for good complaint handling in legal services](#), Economic Insight, 2013

82. [Customer Satisfaction Surveys 2012-2013](#), prepared for the Legal Ombudsman by BMG Research, 2014

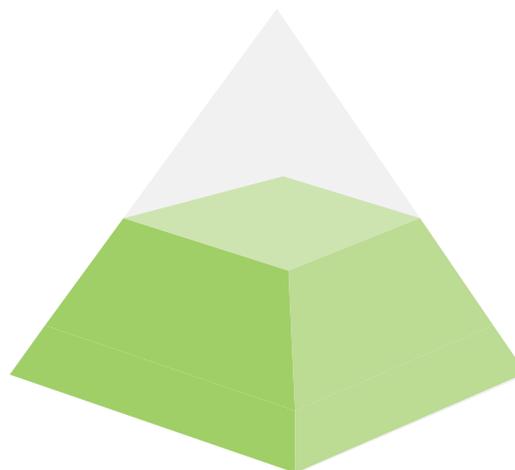
83. Outcome 1.12, You and your client, Code of Conduct, SRA Handbook, Solicitors Regulation Authority, April 2013



## Other priority risks

The following risks are categorised as 'other priority'

- Breach of confidentiality: information security and cybercrime
- Lack of independence
- Failure to act with integrity or ethics: improper or abusive litigation



The risks set out below are a priority, but they are either not currently widespread in the legal services sector, or there are evidence gaps, which means we cannot be certain about the full extent of these risks.

### Breach of confidentiality: information security and cybercrime

Keeping the affairs of clients confidential and secure is a key professional duty. Although there are many risks to information security, cybercrime is the key risk we wish to highlight here.

Cybercrime is an increasing risk, but information security risks are not a new challenge. In the days when law firms operated with entirely 'paper-based' systems, confidentiality could be breached as a result of lost documents or inadequate archiving.

Appropriate use of IT provides an opportunity to minimise these risks, but with it comes new challenges. If well managed, IT systems benefit both the firm and its clients.

### ➔ Negative effects

Cybercrime and breaches of confidentiality can lead to financial or other significant harm to consumers of legal services. Law firms themselves may be destabilised, and this can lead to other risks to consumers. Cybercrime is also a component of the 'bogus firm' risk highlighted earlier in this document.

Cybercrime is a risk to all types of law firm, but there are some characteristics that might increase this risk. Particular attention may be required by firms that:

- handle client money or large amounts of data
- are involved in high-value litigation
- work on high-profile cases or for well-known clients
- possess information that could be targeted for reasons of industrial espionage.

## Trends

Serious online crime targeted at businesses now represents a large proportion of crime on the internet.<sup>84</sup> Most of this type of crime is aimed at gaining access to information such as usernames and passwords.<sup>85</sup> However, there may be many cases where client money or highly valuable data and information are put at risk.

We believe exposure or loss of confidential information is under-reported as in many cases firms will not be aware they have been affected.

The Federation of Small Businesses estimates the average annual cost to small businesses of online crime as £4,000 each and that one in three of its members was targeted in 2012.<sup>86</sup>

### Case study 5:

#### Large law firm loses data to hackers

A solicitor at a large law firm received an email which looked like a message from the firm's answering machine service. He opened it, and this activated software to install a program called CryptoLocker.

Once CryptoLocker had downloaded, it encrypted all the client and office files held by the firm, and a message came through that if the firm wanted the files decrypted, they would have to pay a £1000 ransom within 40 hours. If they did not pay the ransom by the stated deadline, the encryption would become permanent and the firm would never be able to retrieve their files.

The firm's IT department tried unsuccessfully for 2 days to break the encryption. At this point, the firm tried to pay the ransom. However, the

deadline had expired and so the files could not be recovered. The firm had to explain what had happened to all their clients. A number of clients' cases were severely affected, with court deadlines being missed.

This could have been prevented relatively easily. CryptoLocker does not spread across networks, and the only files it can encrypt are those that the user who opens the email can access. Therefore, the only reason it affected all of the firm's files was because the member of staff who opened the email had access to them all. In addition, the firm did not have remote backup of any of their files. If they had done, they would have been able to access the files from the backup and the attack would have failed.

84. [Evolution of Malware: Malware and Potentially Unwanted Software Trends](#), Microsoft Security Intelligence Reports, 2012

85. Lyne, J, [Everyday cybercrime and what you can do about it](#), TED (Video), 13 February 2013

86. [Cybersecurity and Fraud: The Impact on Small Businesses](#), Federation of Small Businesses, 2012

## SRA controls

The Handbook is clear about the duty placed on those we regulate, particularly through Principle 10 - 'protect client money and assets'. Cybercrime is a risk to Outcome 4.1, which states 'keep the affairs of clients confidential unless disclosure is required or permitted by law or the client consents'.

Well-managed IT systems can deliver many benefits to law firms, including the ability to work more flexibly, to deliver value for clients and to make their services more accessible. It would not be in the public interest for us to deter firms from pursuing these goals.

Our approach is to highlight the risks and encourage firms to carry out appropriate due diligence and risk management. Government Communications Headquarters (GCHQ) estimate that 80 percent of cyber attacks could be prevented if businesses follow simple guidance.<sup>87</sup> Most of this is straightforward and inexpensive to implement. It includes basic guidance, such as suitable controls over access to document management systems and ensuring employees do not use personal email to send and receive work related documents.

Over the last year we have published two papers to support this approach. The first of these looked at cloud computing and the second at cybercrime.<sup>88</sup> They include several case studies and examples of good practice.

## Lack of independence

Law firms increasingly work with powerful or dominant clients, and this can present challenges to their independence. Lord Neuberger highlighted the importance and scale of this challenge when he stated.

*'Lawyers owe overriding specific duties to the court and to society, duties which go beyond the maximisation of profit and which may require lawyers to act to their own detriment and to that of their clients.'*<sup>89</sup>

Promotion of a client's interests, or acceptance of a client's terms, or a firm's or individual lawyer's desire to maximise commercial return, should not override these professional principles. Those we regulate must ensure they prioritise their obligations to act in the public interest, in accordance with their duties to court, and must resist client pressure which may adversely compromise their professional independence.

This risk is widespread, but is most relevant to firms engaged in corporate or city-based legal work. It may also be significant when a firm is reliant on a single or limited number of clients. Maintaining independence is also relevant to in-house solicitors, who may come under pressure from their employers.

87. Lobban, I, [Ten Steps to Cyber Security, Executive Companion](#), CESG, 2012

88. [Silver linings: Cloud computing, law firms and risk](#), Solicitors Regulation Authority, 2013; [Spiders in the web: The risks of online crime to legal business](#), Solicitors Regulation Authority, 2014

89. [Lord Neuberger delivering the Upjohn Lecture to the Association of Law Teachers in 2012](#)

**⊖ Negative effects**

When firms allow other objectives to override their duty to act in the public interest this will have a negative impact on:

- the constitutional principle of the rule of law
- the independence of the legal profession.

**▮ Trends**

There is an increasing trend towards corporate buyers of legal services, such as financial institutions and large multinational businesses, having sophisticated in-house legal departments. Many of these companies operate panel, preferred firm and other processes to optimise the value they get from external law firms. This can lead to law firms being presented with ‘take it or leave it’ contracts or prescriptive or onerous terms of engagement.

In turn, many law firms invest significant resources in managing relationships with these clients, creating client teams and vesting partners with responsibility to manage these relationships. Client teams are expected to understand and monitor client culture, governance and risk sensitivity and to deliver legal advice accordingly.

Pressures law firms must manage include:

- pressure to breach ethical or professional obligations – for example, to use a firm client account to provide a personal banking facility, or to knowingly mislead the court, or to breach duties of confidentiality to other clients
- control over which clients the firm can and cannot act for – this could erode access to justice, particularly if the firm is one of few specialists in the area
- being clear about who constitutes ‘the client’ – for example, when acting for a corporate client this may mean distinguishing between the interests of the client’s shareholders, its management and the individual who commissioned the legal advice. These interests are not always aligned.

There may also be situations where clients seek to transfer risks to their law firm. For example, this might involve a law firm being asked to accept liability for the advice of a third party law firm, or to indemnify a client for any loss arising from a matter. When risk and potential liability are transferred, it is important the firm identifies and understands the risk it is taking on and has a strategy to manage this.



### SRA controls

Those we regulate must adhere to:

- Principle 1 – ‘uphold the rule of law and the proper administration of justice’
- Principle 2 – ‘act with integrity’
- Principle 3 – ‘do not allow your independence to be compromised.’

We acknowledge that the professional principles can, and do, come into conflict with each other. However, when professional principles come into conflict, the one that best serves the public interest, in the particular circumstances, prevails. This is especially the case when the proper administration of justice is at risk.

Through our supervision of firms we will explore how these risk are managed by law firms and aim to understand better the challenges firms face. We will share best practice on how firms manage these issues and balance their ethical responsibilities with commercial success.

### Failure to act with integrity or ethics: improper or abusive litigation

Improper or abusive litigation is the misuse of legal proceedings (or the threat to bring proceedings) for unethical gain, either for the law firm, its clients or both. This is done by exploiting a client or third party’s lack of knowledge of the law or the lack of resources available to them.

Improper litigation also includes manipulation of criminal proceedings, both in terms of how clients plead to charges, such as by defendants under the age of 18 pleading guilty in an attempt to protect an adult defendant, and attempts to overcharge, especially in the context of costs claimable by defendants when cases are dropped.

### Negative effects

The direct impact of improper or abusive litigation is usually financial loss or reputational damage to a client or third party. In some cases it can lead to serious miscarriages of justice. In addition, it can have a significant negative impact on the public’s perception of the integrity of law firms and wider confidence in legal services.

### Trends

Trends are hard to identify, but we continue to see cases where litigation is used to exploit clients or the justice system. The most well-known examples of improper or abusive litigation are historical. This includes the miners’ compensation scandal, where vulnerable clients were charged improper costs or other deductions from damages. Another example found improper by the SDT involved a law firm sending lengthy and complex letters to individuals threatening to take legal action, including some with reference to embarrassing details which could be made public. Recipients of these letters were asked to pay an arbitrary amount in damages as well as unjustified legal costs. These cases not only caused loss and distress, but they also have wider implications for people’s trust in law firms and trust in the rule of law itself.

Other examples of problems in litigation include:

- firms being criticised by judges for aggressive correspondence in corporate litigation or accused of unethical conduct towards witnesses or their statements
- judges highlighting serious concerns that ‘frivolous’ litigation was being brought forward by lawyers
- the High Court warning that immigration solicitors face referral to the SRA if they make ‘abusive’ judicial review applications which fail to follow proper procedure<sup>90</sup>
- a number of cases where judges have dramatically reduced excessive costs claimed in litigation, sometimes by over 90%.

 SRA controls

Many cases of improper or abusive litigation involve a fundamental failure to act with integrity and ethics. Serious cases go to the Solicitors Disciplinary Tribunal and solicitors have been struck off for this type of activity.

The Government has brought in changes to the Civil Procedure Rules to tackle the large number of judicial review applications which it calls ‘weak, frivolous and unmeritorious cases, which congest the courts and cause delays’.<sup>91</sup>




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90. [England and Wales High Court \(Administrative Court\) Decisions, Hamid, R \(on the application of\) v Secretary of State for the Home Department](#), Bailii, 2012

91. [Reform of Judicial Review: the Government response](#), Presented to Parliament by the Lord Chancellor and Secretary of State for Justice by Command of Her Majesty, April 2013; [Judicial Review: Government reforms - Commons Library Standard Note](#), HM Government, 2014

## Case study 6:

### Manipulation of criminal proceedings

Mr Blue had been the solicitor for the Silver family for ten years. Mr Silver approached Mr Blue to ask him to represent his son J who had been arrested for his involvement in a drug deal.

Mr Silver asked Mr Blue to track down his son's younger friend, T, who he said had been with him when he was arrested but had since been released, pending further enquiries.

T was a minor - only 15 years old - and the penalty if he pleaded guilty would be less than if J, who at 23 years was an adult, was convicted. Mr Blue attempted to convince T that he should confess to being the main instigator of the crime and he included a threat that if he did not, the Silver family would sue him and his parents for a lot of money.

T was intimidated by the situation and as he knew very little about the law he agreed to plead guilty and asked Mr Blue to represent him. T's mother visited him in custody soon after he had confessed and he revealed the threat Mr Blue had made. His mother immediately complained to the police.

Following a lengthy police investigation Mr Blue was arrested and prosecuted for attempting to pervert the course of justice. Following a trial he was sentenced to several years in prison. He was also struck off the roll of solicitors.

# Conclusions

The way a risk affects each firm will be different depending on the type of services they offer, their size and the clients they work for.

There are also different approaches to managing these risks – no one solution will fit all firms. We do not want to be prescriptive in telling firms there is one right way to comply with our regulations, or one way to reduce risk. Instead we want to encourage firms to look at risks from their own perspective and take reasonable and proportionate steps to manage them.

Good risk management will help us to protect and promote the public interest, whilst allowing law firms to achieve their own strategic goals.





The Risk Outlook is available in alternative formats.  
Please contact 0370 606 2555