



Consultations

Outcomes-focused regulation - transforming the SRA's regulation of legal services

Annex B - Why the SRA is considering the financial stability of firms

30 April 2010

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- 1. Financial instability can be caused by a range of factors some of which are in the control of firms and some which may not be. External factors that may affect a firm's financial strength and capability may include
 - poor trading conditions locally nationally or internationally,
 - interdependency with other sectors in difficulty,
 - availability of credit and economic conditions generally,
 - changes in social behaviour or legislation, and
 - new or increased competition.
- 2. Factors more closely controllable by firms that may impact financial strength and capability may include
 - ineffective financial management and controls,
 - poor partner and staff retention and management,
 - over-dependence on single market, client or contract, and
 - poor business planning.
- 3. It is clear that any one factor or a combination can put a firm at risk of insolvency. However, if the internal factors are well managed, it is likely that a firm should be better placed to address the external factors.
- 4. Furthermore, financial instability can create pressures upon individuals within firms that can lead to dishonest behaviour. For example, a conveyancing firm may be reliant upon the state of the economy and the housing market in particular; cash-flow pressures due to fewer transactions might lead to a partner dipping into the



client account fully expecting to pay it back the following month, only for the following month's figures to be as bad or worse. In this instance the state of the economy has had a major impact on a firm with insufficient controls to prevent a fraud.

- 5. The impact upon consumers of either insolvency or fraud can be significant. For individuals, many are engaging with firms at a time of personal stress such as while moving house, getting a divorce or following the death of a family member. For commercial clients the disruption can have additional financial ramifications and cost.
- 6. Additionally, there are wider considerations about the impact of these instances upon access to justice. In some areas, the loss of legal firms may leave communities with limited access to local legal advice with further impacts on consumers.
- 7. The work done in preparing for these changes has involved extensive engagement with firms of many sizes and other interested stakeholder groups. Further, the SRA has worked closely with peer regulators in other sectors to understand what can be learnt (for example, the SRA gathers less information on its regulated entities than most, if not all, of its peers).
- 8. However, for the avoidance of doubt, the SRA has no responsibility to prevent firms from failing but where possible it believes that the orderly wind-up of firms is preferable.

Outcomes related to financial stability

- 9. The SRA has had to intervene in failing firms more frequently, especially since 2007, which suggests that more consumers are being impacted by this, and more firms are in getting into difficulty. This also results in greater cost to the regulator (and therefore the profession). Unfortunately the SRA is often made aware of the problems too late to either promote the orderly wind-up of a firm (transferring clients to other firms etc.) or, better still, the survival of the firm.
- 10. The outcomes the SRA is seeking, therefore, are
 - risk-based regulation which is targeted and proportionate,
 - better financial management within firms,
 - more orderly winding-up of firms where necessary, and
 - reduced opportunities for fraudulent behaviour.

Means of achieving the desired outcomes

- 11. Primarily, the SRA acknowledges that it needs to take a more proactive approach to both the assessment of risk and engagement with firms on financial management but that any measures should be appropriate and proportionate.
- 12. At present firms are required to retain reporting accountants to produce an annual report on compliance with the Accounts Rules which is then provided to the SRA. Otherwise, it is only upon



authorisation or renewal, if complaints are received, or on notification of closure of the practice that the SRA receives information on firms and this is insufficient to effectively assess the potential risks firms face.

- 13. Therefore, the SRA has identified circumstances in the lifecycle of firms when either the regulator could request information or firms might be expected to notify the SRA—most often through self-reporting but supported by the potential for firm visits and audited reports where appropriate.

Point in life cycle	Potential risks	Potential notification and reporting requirements
Authorisation of the firm	Poor business planning "Phoenix" firms*	Business plans
		Partner and senior staff CVs including experience, qualifications and training
		Six-monthly self-reporting for first 24 months Accountant's Report
Established and operational (+two years onwards)	General risks to client money through poor management or dishonesty	Data on annual turnover
		Self-certified reporting on management information
Significant changes to the firm: e.g. entry into new market/acquisition of another firm; material proportion of partners/employees leaving	Poor business planning	Firm visits by the SRA
	Overextension/inadequate funding	Firm to notify SRA of changes
	Loss of significant clients	
	Loss of confidence of some partners/staff	



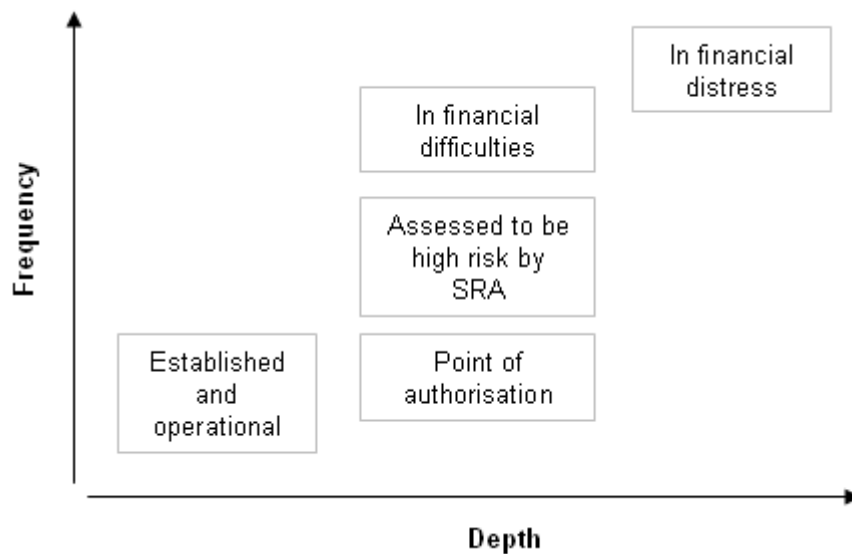
Sector and sub-sector risks identified e.g. changes to economy, new legislation etc.	Increased exposure to difficult market conditions	SRA may request additional data from firms operating in higher risk sectors
Firm in financial difficulties	Increased risk of fraud and loss of client money Risk of insolvency	Firm to notify SRA when it considers itself in difficulties –e.g. requires significant borrowing in order to remain a going concern More frequent self-reporting
Firm in distress	Increased risk of fraud and loss of client money Increased risk of insolvency	Firm to notify SRA when it considers itself in distress e.g. breaks bank covenants, cannot obtain finance
Firm wound-up	Potential intervention Disorderly wind-down and intervention Clients stranded	More frequent reporting Firm to notify SRA in advance

(A "Phoenix" practice is one that has been wound up and restarted, usually under a different name. This is often to avoid creditors. Consumers are considered likely to be at greater risk from a serial phoenix firm.)

- 14. The SRA is responsible for the regulation of firms of all sizes and across many legal services—a "one size fits" all approach would be inappropriate. As such, the risk-based approach will consider the frequency, depth and breadth of information required to focus efforts and support where it is most needed.
- 15. The means of information sharing between the SRA and firms can be broadly summarised in the following categories:
 - Third party reporting – e.g. the Accountant's Report – currently on an annual basis
 - Self-reporting/certification – e.g. providing information on turnover, business plans etc. – currently minimal
 - Event driven notification by firms – e.g. at present upon closure
 - Regulator visits to firms – e.g. Practice Standards Unit (PSU) visits.



- 16. The frequency and depth of information gathering will need to be a pragmatic response. The diagram below suggests a means of assessing what may be appropriate.



- 17. The value in gathering data will clearly be largely dependent upon how effectively it is applied and analysed by the SRA. However, it should be recognised that the framework for notification and reporting in and of itself sets expectations of firms and sends a message to stakeholders more widely about what standards of financial management the SRA expects of firms.
- 18. The SRA is concerned that this increase in data requested by the SRA should not become an onerous and unreasonable burden and notes that much of what will be requested is currently provided by firms to banks and insurers. Also it is considered essential that the appropriate internal controls are in place within the SRA to respect the confidentiality of information provided.
- 19. Upon receiving applications for authorisation, the SRA will carry out a risk assessment based upon the data provided. Its options will be to grant the application, grant the application with additional licence conditions, or reject the application. The licence conditions set may include specific requirements for more frequent reporting or the reporting of specific data.
- 20. Upon receiving the Accountant's Report and additional information from firms the SRA will be in a position to revise its risk assessment, request further information, point firms in the direction of advice and/or provide advice about the risks they face and potential means of mitigating these risks.
- 21. It is evident that taking this revised approach will result not only in significant change but will require effective communication and setting of appropriate expectations with consumers, additional support for firms, not to mention new skills and resources for the SRA.



- 22. This is a dynamic process so firms will see their relationship with the SRA in terms of the requesting and sharing of information change over time.
- 23. Fundamentally, it is hoped that by requiring the right and proportionate level of information from firms, supported by fair and reasonable analysis, firms may be encouraged to manage their businesses more effectively to the benefit the firms, the profession, the SRA and, most importantly, clients.
- 24. The exact nature of the reporting and notification framework is still at an early stage of development. The SRA is currently developing more detailed proposals to be presented for consultation in October 2010. In advance of this, the SRA will be holding further informal stakeholder consultation.

1. Do you have any comments about the risks arising from the current financial management of firms?

2. Do you have any comments regarding the SRA's responsibilities for addressing the financial stability of firms and its proposed desired outcomes?

3. To what extent do you consider the proposed response outlined in this section meets the objectives of outcomes-focused regulation?

4. Do you have any suggestions regarding what information may be requested of firms and how frequently it may be requested?