Expert analysis 5: Outcomes-focused regulation – Its impact to date and thoughts on likely future repercussions

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THE GENESIS of this article arose from observations I have made over the past 12 months or so as I have worked daily with law firms on their strategic direction, financial management, performance issues, and their risk and compliance management.

I have come across law firms where the impact of outcomes-focused regulation (OFR) appears on the face of it to have been almost 'zero' in that some firms and individuals seem to have put their heads in the sand and seem not to know anything about OFR, hoping it will go away. Such firms are not the main focus of this article, although the negative attitudes towards OFR which exists should be a cause for concern, both to the profession as a whole and to the SRA. Perhaps the question which needs to be asked is: Could OFR and its objectives be better communicated to the profession?

The encroachment of regulation

OFR is not simply a different way of approaching law firm regulation. OFR has, importantly, extended in a number of ways the boundaries of regulation, and consequently its impact on the way law firms operate. This increasing encroachment of regulation through OFR into every aspect of a law firm is clearly shown (and has largely been driven) by Principle 8 in the SRA Handbook (with much of the 'meat on the bones' being provided by Chapter 7 of the SRA Code of Conduct).

According to Principle 8: 'You must … 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.' Running a law firm in accordance with that Principle should make good business sense and many law firms have for long been managed in such manner. However, because the management of law firms is now not just a matter of good management practice but also a compliance issue, then that is likely to lead to a 'tick box' approach by some in order to just be compliant, rather than a true striving for better standards and performance across a range of management disciplines.

A particular example of this extension of regulation is in relation to outsourcing. 'Outsourcing' is not defined in the SRA Handbook but a note on the SRA website refers to 'solicitors who use a third party to undertake work that the firm would normally do themselves and for which the firm remains responsible', and Outcome 7(10) refers to 'any operational functions that are critical to the delivery of any legal activities'. Outsourcing has become a part of the way of life for many organisations, whether businesses or even government. As business processes have become more complex (and more expensive) so law firms have increasingly used outsourcing for a multitude of business process activities, ranging from secretarial services to IT functions.

Outcome 7(10) of the Code of Conduct requires law firms which outsource activities 'to ensure that outsourcing is subject to contractual arrangements that enable the SRA ... to obtain information from, inspect the records of or enter the premises of, the third party in relation to the outsourced activities'. The SRA note adds that they 'would expect all new outsourcing agreements to contain provisions that meet this outcome' and, in relating to existing outsourcing agreements, 'we are unlikely to take action against firms before 6 April 2012 purely on the basis that an agreement does not include specific terms to meet this outcome. However, we would expect you to have taken reasonable steps to ensure that the SRA can obtain access to relevant information if necessary'.

A firm of solicitors (even a large firm) may find it difficult to persuade a large outsource provider to change its standard terms of business and it will be interesting to see the extent to which firms are able to achieve this outcome and the approach to its enforcement by the SRA.

Compliance requires greater resources

Possibly the most immediate and manifest consequence of OFR on law firms has been the recognition that greater resources (of people and finance) are required if law firms are to achieve and comply with all the Principles, rules, outcomes, and other requirements of the SRA Handbook. To manage compliance effectively, even for large and well-resourced law firms, is a challenge.

The majority of law firms have less than 10 partners and very little support infrastructure in the form of financial, HR, marketing, IT, and risk and compliance management. For them to be compliant will require them to have access to a wide range of professional disciplines which they either do not currently or adequately possess, and which they cannot see how they can afford. Worse still, the problem for very small firms (such as sole practitioner practices) of finding the resources to manage OFR compliance is in reality becoming an issue which is likely to determine whether they survive or not. Whilst many such firms realise they must take steps to be compliant, given the difficult economic circumstances being experienced by many, they cannot see how they can afford to do so. However, the question which they need to ask themselves is: Can we afford not to? That is the conundrum which many firms are now facing.

The need for greater resources if law firms are to be compliant under OFR is evident in several areas. On 1 January 2013 the responsibilities of the new compliance officers each law firm must have – the Compliance Officer for Legal Practice (COLP) and the Compliance Officer for Finance and Administration (COFA) – go 'live'. Given the client work and other roles many of the nominated COLPs and COFAs already have, how will they be able to effectively fulfil their roles given that, in reality, for the roles to be performed well they will need to be full time or near full time? Whether in a large firm or a small firm, the most practical way forward is for teams to be built around COLPs and COFAs. However, even if supported by a team, COLPs and COFAs will still need to be 'on top of' their responsibilities. Small firms will say they cannot afford to build teams and larger firms may have difficulty in finding appropriately experienced people.

The cost of managing risk

Even for larger firms, the need to find the resources to manage OFR compliance can

be no less acute. As law firms grow and expand, they become more sophisticated and complex organisations requiring a far greater breadth and depth of high quality management. Moreover, the risks associated with practice for large firms are now assessed by the SRA as being higher, leading to 'relationship managers' being assigned to some 200 of the largest law firms. Under Principle 8, risk in its broadest sense must now be managed if a firm is to be compliant and the paradigm shown in Figure 1 attempts to summarise a number of the more important risks to which law firms are subject.

What resources are now required by a larger firm if it is to put in place an effective team around a COLP and a COFA to manage such risks? Professional risk and compliance personnel such as the ones listed below are now being recruited as a direct result of large firms recognising that they must ensure they are compliant with OFR:

- Legal counsel;
- Risk and compliance directors;
- Compliance training managers;
- Quality standards managers;
- AML compliance managers;
- Data Protection managers; and
- Complaints handling managers.

Providing the people resources to effectively manage compliance will be expensive. However, those are costs which will inevitably have to be incurred with the introduction of OFR. Even smaller firms are likely to have to consider recruiting compliance professionals to help them to effectively manage their OFR compliance, although it is unlikely that most will do so.

The increased cost of compliance is likely to reduce margins even further at a time of economic difficulty and uncertainty. Alternatively, some law firms will try to pass on these costs to clients. Neither of these consequences was the intended objective of

Figure 1: Law firm risks

the Legal Services Act 2007 which brought about OFR.

Financial stability

Prudent financial management should be a priority for all businesses. For law firms, financial management is now, under OFR, a matter of mandatory compliance. Outcome 7.4 of the SRA Code of Conduct requires that law firms 'maintain systems and controls for monitoring their financial stability ... and take steps to address issues identified.' The SRA is clearly concerned as to the financial position of some law firms and laudably wishes to avoid further law firm failures. However, 'financial stability' is not defined. So what does it mean and what will a law firm need to do to achieve such an outcome?

Whilst some of the 'indicative behaviours' in the Code of Conduct shed light on what may be required, other indicative behaviours add to the uncertainty. For example, indicative behaviour (10.4) talks of 'notifying the SRA promptly when you become aware that your business may not be financially viable to continue trading as a going concern'. Did the SRA intend to use the term 'going concern' in its technical accounting and audit sense, and if not, then what is it intended to mean and what are the implications for law firms?

A law firm which is an LLP or a company is subject to certain statutory audit requirements and accounting standards. An example of this (taken from the recent financial statements of an LLP law firm) states that: 'After making enquiries, the management team has a reasonable expectation that the LLP has adequate resources to continue in operational existence for a period of no less than 12 months from the date of signing the financial statements. Accordingly, we continue to adopt the going concern basis in preparing the annual report and financial statements'. Will that, in due course, become the test to be applied to all law firms (including partnerships and sole practitioners) to ascertain whether they are meeting the financial stability outcome? If that test were to be applied today to all law firms, how many would be able to meet it?

What is clear is that as a result of the introduction of OFR, law firms are going to have to give greater priority to their cash management if they are to be compliant. This will require them to put in place more stringent and effective financial procedures to accelerate cash flow. This in turn will require them to take steps to ensure that partners or other owners are prepared to be managed and accountable, without which a firm will not be able to successfully put in place the good financial disciplines which must be adhered to by everyone in a firm if 'financial stability' is to be achieved.

However, the principle of 'accountability' in relation to OFR has a far broader application that just in relation to financial matters.

Using OFR to deal with 'bad behaviour'

There can be an added benefit to be achieved from the introduction of OFR which some law firms are now beginning to put into practice. A law firm is very much like a chain – it is only as strong as its weakest link. If anyone in a firm does not follow procedures then that person is the weak link and that can mean disaster for a firm.

Unless a firm first gets its partners into shape and everyone agrees to be 'accountable' by undertaking to be managed and to do whatever is required to be compliant, then a firm is unlikely to be able to achieve any outcomes under OFR. 'Zero tolerance' in relation to OFR compliance is now being required by many firms, with sanctions on those who do not comply.

Many law firms have partners who are not prepared to be managed and who will typically say things such as: 'You can't manage me – I am a big biller!' and 'You can't tell me what to do – I am as much an owner of this firm as you!' In the absence of any real notion of accountability on the part of all partners in a firm then the responsibilities of COLPs and COFAs will be unworkable.

Some firms are turning OFR to their advantage and using the introduction of COLPs and COFAs as a means to deal with the lack of accountability on the part of some partners. As a managing partner said to me recently: 'I have told my partners that if I have to do the job, then we are first going to have a serious debate within this firm as to how it will be managed in the future!' Firms are now putting in place internal governance arrangements whereby all partners are contractually required to be compliant with all regulation and to do everything necessary to enable the COLP and COFA to effectively carry out their respective roles. Indemnities against potential liabilities on COLPs and COFAs in the event that partners breach their obligations are being included in such arrangements. 'Zero tolerance' is becoming the new law firm mantra as far as OFR is concerned.

The potential for conflicts

The position of a COLP and a COFA is likely to be a difficult one, as the roles do not sit comfortably within the structure of most 'traditional' law firms (as opposed to ABSs for which the roles were originally intended). In particular the need for COLPs and COFAs to have an 'independence of role' can only lead to increased conflicts within law firms, between COLPs and COFAs on the one hand and either management (as it tries to drive forward the firm to achieve its goals) and/or other partners who may not be compliant on the other. We will see over the next few years whether the COLP and COFA roles are workable or not. In the meantime it is likely that the 'policeman' roles of the COLP and COFA will drive more partnership disputes.

The need for law firms to lay an 'audit trail'

The requirement under OFR to achieve, for example 'financial stability', has focused the minds of those who are managing law firms (as well as those nominated as COLPs and COFAs) on the need on the part of everyone in a firm to lay 'audit trails' in relation to every decision made and every action taken, so that if challenged a firm and its people are able to explain and justify why they acted in a particular way.

'If you cannot demonstrate compliance, we may take regulatory action'. That statement appears in 'Outcomes Focused Regulation at a glance' on the SRA website.[1] It is likely to have a profound effect on how law firms (and all of their people) operate in the future. Everything will need to be documented in order to at least provide arguments and some protection against allegations of non-compliance. At the same time it is likely that law firms will more frequently seek to take external advice from accountants and other professional advisers whenever issues arise (for example in relation to financial stability). If advice is taken and obtained then it will need to be carefully documented and followed, or if it is not taken, then justification for not taking such advice is likewise to be documented.

OFR as a catalyst for forward planning

The growing realisation by law firms that they may not have the resource capability to

be compliant with OFR is likewise leading some firms to conclude that they may also not have sufficient resources to achieve their strategic objectives and to be competitive in their markets.

OFR has for many, focused their minds on how they are going to cope with their futures. If a law firm is clear as to which services its clients are going to need in the future and it has identified the skills and behaviours which will be needed on the part of its people to deliver those services to clients, then it will need to construct a realistic plan if it is to build its competitive edge. The plan will need to be clear, have achievable objectives and, importantly, detail the resources required to enable the firm to achieve those objectives. Law firms will not be able to successfully deal with the challenges facing current and future legal practice unless they have sufficient resources to do so. They will, for example, need to consider how they are going to:

- Provide clients with the 'value for money' services clients increasingly now require, in order to gain a competitive edge over rivals;
- Provide the management infrastructure now required if firms are to manage and develop their businesses successfully (and compliantly); and
- Achieve the specific objectives they have set themselves within given timescales.

In particular, the people resources required will need to include not only good lawyers, but also provide excellence covering a wide range of roles, including those relating to leadership and in areas of senior management such as finance, business development, HR, IT, knowledge management, training, and risk and compliance.

To provide, in particular, the people resources necessary and to fulfil other resource needs on a basis sufficient for successful legal practice now and in the future will require a level of financial resource which is likely to be beyond the pocket of all but the larger and most profitable law firms. For example, how many firms are likely to be able to afford to build comprehensive risk and compliance teams? This has inevitably led to the conclusion by many that consolidation in the legal profession at all levels is now required – witness the recent spate of mergers between large firms. The profession is highly fragmented and law firms are waking up to the realisation that they cannot achieve their objectives on their own.

If the introduction of OFR has contributed to the growing momentum towards more law firm consolidation, then that is a welcome by-product of the new approach to regulation which OFR has introduced.

References

1. See: www.sra.org.uk.