



Back
to
School

Welcome back: Post-holiday planning

With the summer holidays coming to an end, your thoughts may be turning to your management tasks for this year end, and into 2008. This article provides some 'back to school' planning tips for the regulatory year ahead. By Frank Maher

Holidays over, and the thoughts of the law firm finance director or CEO returning to the office will turn to what needs to be done to bring the firm into shape. What are other firms doing and how is the general legal landscape developing, for example? This article focuses on some of the issues that the larger firms have been consulting the writer's firm about in recent months. We will look at the Money Laundering Regulations, the Code of Conduct, the Legal Services Bill and, finally, with most firms yet to renew their insurance for 1 October, the professional-indemnity renewal.

Money Laundering Regulations 2007

The Money Laundering Regulations 2007 come into force on 15 December 2007. Note that these cover both anti-money laundering and counter-financing

of terrorism, an important aspect often overlooked in firms' training plans. They will impose significant new obligations on firms in relation to 'customer due diligence' (CDD), which in turn will increase the training and compliance requirements for all firms.

The meaning of CDD is explained in regulation 5:

5. 'Customer due diligence measures' means –
 - (a) Identifying the customer and verifying the customer's identity on the basis of documents, data or information obtained from a reliable and independent source;
 - (b) Identifying, where there is a beneficial owner who is not the customer, the beneficial owner and taking adequate measures,

on a risk-sensitive basis, to verify his identity so that the relevant person is satisfied that he knows who the beneficial owner is, including, in the case of a legal person, trust or similar legal arrangement, measures to understand the ownership and control structure of the person, trust or arrangement; and

- (c) Obtaining information on the purpose and intended nature of the business relationship.

The impact of this is further reinforced by regulation 7, which provides:

- (3) A relevant person must –
 - (a) Determine the extent of customer due-diligence measures on a risk-sensitive basis

- depending on the type of customer, business relationship, product or transaction; and
- (b) Be able to demonstrate to his supervisory authority that the extent of the measures is appropriate in view of the risks of money laundering and terrorist financing.

Regulation 8 requires ongoing monitoring of business relationships.

This statutory requirement to adopt a risk-based approach means that, if firms were not doing it already (and they should have been having regard to the Law Society's 2004 guidance), they must conduct a thorough review of their practice and client base, implement appropriate procedures and, most importantly, document their decision-making process.

Compliance is therefore far more than a client or matter-inception issue; in the writer's view this was the case under the 2003 regulations, but it is now incontrovertibly so. The regulations will require the Solicitors Regulation Authority (SRA) to monitor firms' compliance. This will all heighten the need for both regular training and audit.

Larger firms in particular are taking the opportunity to review their whole matter-inception process (though CDD is not just limited to matter inception), and international firms are taking the opportunity to review processes Europe-wide, as the European Directive that gives rise to the regulations will impact in all EU member states on a broadly similar basis.

Substantial new Law Society guidance is due to be released as this article was written. All firms will have to consider how it impacts on their business processes.

Many firms undertook firm-wide training when the previous regulations came into force in 2004. Some have allowed that to lapse since then, with new recruits being overlooked and insufficient consideration being given to the need to

carry out refresher training – every two years would be prudent for most staff – to maintain levels of awareness.

A number of the larger firms formed a consortium to produce an industry-standard online training course, which has since been adopted by many of the other larger firms. Those who adopt this route will ensure that staff have been trained consistently and that they have records to prove it. There will still be a need for other types of training, however, for those in key positions.

Firms should be under no illusions as to the mountain they will have to climb to ensure compliance.

Solicitors' Code of Conduct 2007

The Code of Conduct came into force on 1 July 2007. The prospect of unlimited fines for breaches of the Code should focus minds – the current limit of £5,000 per offence is set to be removed by the Legal Services Bill.

There are two aspects to this: first, firms need to ensure their procedures are compliant; and second, staff must understand their obligations. Many firms implemented firm-wide training to raise staff awareness of the requirements. From the staff point of view, the most important area where enforcement action may be most likely, is the enhanced obligations on client care and a reminder of the costs information requirements in rule 2.

Conflicts and confidentiality rules are largely unchanged (apart from one minor change in the guidance on confidentiality) but with conflict issues being so much in the spotlight, many firms have paid special attention to this area. A particular problem with conflicts is that it is not simply a matter of doing a conflict search, nor is it even just a matter-inception issue. A conflict search only provides the material for a fee earner to make a decision, and it is only as good as the information put in by others in the first place (for example, most firms fail to record sufficient

information on the matter description). The more difficult problems in practice are those that emerge during the currency of a matter.

The conflict rules contain two exceptions – the competing bidder exception, which has had the most press but appears to be relied on in practice by only the smallest handful of the very largest firms and, second, where two or more clients have a substantially common interest in the same or related matters. The latter is likely to cause many problems. Of course it makes sense, and always has done, for parties with a substantially common interest to share the costs of legal representation. The key skill is in anticipating at the outset where their interests may diverge, ensuring clients understand this from the start and agree how the matter will be dealt with in the event that situation arises. It requires a measure of skill in documenting this at the outset – a topic ideally covered in conflicts workshops. Defendant insurance firms in particular should focus on this issue.

We never have to act for more than one client and by doing so we take a risk. The important thing is to make sure that it is a calculated risk, and that the risk is managed, not simply allowed to unfold.

Avoidance of conflict issues, along with other aspects of client engagement and matter management, has been covered in an online risk-management training course produced by a consortium of leading UK law firms similar to the anti-money-laundering training referred to above.

Rule 5 of the Code requires principals to implement procedures for compliance with a number of important requirements including conflicts, and anti-money laundering. For the first time, however, they are also required to implement procedures for managing risk and for business-continuity management – and to be able to demonstrate that they have done so.

Some of the larger firms have been implementing risk audits, with or

without external assistance, to establish their levels of compliance and produce an action plan: if you do not have a plan, how can you demonstrate that

large firm found out when a water tank burst on the roof.

It is important to ensure the firm has a plan: too often, firms have a draft that

Firms should be cautious, however, because they risk committing serious breaches of the Code of Conduct in the process. The full force of the disciplinary process has in the past been brought to bear on those who tried to steal a march on their competitors by taking steps under proposed rule changes before they came into force.

you are managing risk? This requires a structured approach involving detailed interviews with heads of practice areas and other key management personnel, including those responsible for human resources, information technology, finance and accounts. Ideally, it will also include some investigation of the issues with those at the ‘coal-face’, the fee earners, as their perspective may differ. This can be done conveniently with online testing. In the writer’s experience, it often reveals important issues, such as failure to understand the firm’s conflicts procedures. In one large firm tested recently, only 60 per cent were confident that their department had an effective back-up diary system, yet this is a frequent issue on claims.

Rule 5.01(1)(k) of the Code requires provision for “the continuation of the practice of the firm in the event of temporary absences and emergencies, with the minimum of disruption to clients’ business”. Although minds often turn immediately to incidents such as the Bishopsgate and Manchester bombs, the Buncefield explosion in December 2005 and natural disasters such as Hurricane Katrina, far more mundane issues can cause problems too, such as the recent floods, which affected at least one top-100 law firm significantly. Floods can even happen on upper floors of office blocks, as one

is never quite finalised, not tested, and not communicated to staff.

Legal Services Bill

A number of firms are considering the options to hive off parts of their practices or introduce external ownership as soon as these are permitted. Although the Legal Services Bill is set to reach the statute books in the autumn, barring a general election of course, the provisions permitting Alternative Business Structures (ABSs) are not expected to be in force before 2011. Some firms are trying to ‘jump the gun’, and the writer’s firm has been involved in advising both law firms and in-house legal departments on a number of these issues. Firms should be cautious, however, because they risk committing serious breaches of the Code of Conduct in the process. The full force of the disciplinary process has in the past been brought to bear on those who tried to steal a march on their competitors by taking steps under proposed rule changes before they came into force.

Professional-indemnity renewal

All firms in England and Wales renew their primary professional-indemnity insurance on 1 October each year. Despite this being a known fact with no surprises, the reality is that most renewals are finalised in late September.

Legal Risk’s ‘Top 100 Professional Indemnity and Risk Management Survey 2007’ showed that at last year’s renewal, two thirds of the firms responding (excluding Scottish firms, which renew on 1 November) renewed in the last two weeks of September and a remarkable 45 per cent in the last week – up from 32 per cent in the 2005 renewal.

This is probably indicative of the state of the insurance market – highly competitive with low premiums. Last year they were reduced from the previous year’s levels for compulsory primary cover), and the writer suspects that firms had an offer in good time but were holding on to see if they could improve on it.

Few changed insurers, suggesting that shopping around was generally with a view to negotiating the best deal with existing insurers. Market conditions are such that a similar outcome seems likely this year.

One of the dangers of cheap insurance is that insurers may be tolerant of failures to make full disclosure in the renewal process – not just in the proposal form but at any time after it prior to the insurance being placed.

Many firms still rely on a circular to partners, only asking if they are aware of anything that needs to be notified to insurers. This is not enough: the proposal form will usually contain a warranty that they have asked all staff – not even limited to fee earners. Online testing of a cross-section of staff at one well-respected firm recently using Desktop, a risk management diagnostic tool, revealed that seven per cent of staff did not know whom to inform of a potential claim and 20 per cent did not know what they were required to notify – even one failure in this area could cost the firm substantial amounts in the event of a coverage dispute with its insurers.

Firms need, therefore, to ensure that they have done a comprehensive trawl of all staff, including support staff – they alone may know of problems that

need to be notified, and asking them may also be the firm's protection against fee earners concealing problems. The request needs to be in plain English, not referring to technical terms in the policy such as 'circumstances', which have complex meanings. Ask for staff to notify 'mistakes or complaints', which should cover what you need to know about and a little more. Keep a log of responses and make sure everyone replies.

Are you buying enough cover? Remember that the 'aggregation clause' in an insurance policy, which means insurers can treat multiple claims arising from similar causes, may mean that in reality you have less cover than you think. What if one major incident kept staff out of the office causing multiple missed time limits (we looked at business continuity earlier)? Or say an error was uncovered in the rent-review clause in the firm's standard lease precedent. These issues could mean cover was insufficient. How does your level of cover compare with other firms? Further information on this and other insurance-related questions can be found in Legal Risk's Top 100 survey.

Conclusion

Firms need to sort their professional indemnity renewal by 1 October if they have not already done so, but the requirements of the Money Laundering Regulations 2007 and the Code of Conduct cannot be allowed to rest much longer. Firms may have made a start on the Code of Conduct, but it is an ongoing process and has to be kept under constant review. ■

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Legal Risk's 'Top 100 Professional Indemnity and Risk Management Survey 2007': KEY FINDINGS

Who is your broker?

We expected significant movement of personnel between brokers to be reflected in the number of firms changing brokers, and nearly one in six did so, as against seven per cent in last year's survey. However, the number changing was less than the previous high of nearly one in five in 2004.

If you changed broker, why did you do so?

Service, personal relationship and the broker's market position were given as the reasons in almost equal measure.

What was the basis of payment to your broker?

Ninety-four per cent of respondents pay a fee, six per cent commission (as against nine per cent in 2006). One firm was half fee, half, commission.

How much cover did you obtain?

Last year we noted that firms were buying more cover. We know through our clients that the larger firms have been increasing and, in many cases, doubling their excesses since the open market began in 2000, freeing up cash to spend on the higher levels of cover. This year, our survey revealed a marked increase in the number of firms with high levels of cover – ten per cent bought over £200m, and a further 19 per cent had in excess of £150m.

When did you finalise cover for 2007?

In 2006, even more of the action took place at the end of September – two thirds in the last two weeks, and a remarkable 45 per cent in the last week, up from 32 per cent last year.

Do you limit liability contractually?

Last year, we asked this question for the first time and found that only 9.3 per cent of firms did not limit liability at all, as against 80 per cent in the City of London's Law Society survey in 1999. This year it is down to 5.3 per cent.

Do you have Limited Liability Partnership status?

Limited Liability Partnership status has gained further ground this year with over half the respondents (52 per cent) now having converted and only 29 per cent having no plans to do so.

Did you change insurer this time?

Only three per cent changed this year, down from last year's already low figure of 7.4 per cent. Cost was the only reason.

Full details of the survey can be found at www.legalrisk.com