

Contents

Internal audit	1
Financial Crime	1
Professional indemnity insurance	1
SRA	2
Client requirements	2
General Data Protection Regulations (GDPR)	2
And finally...	2

Articles

[A rogue in your midst \(Pt 1\)](#)

Frank Maher commences a series of articles on rogue partners & employees. First Published in New Law Journal October 2016.

Events

[Ark Group Risk Management & Compliance for Law Firms 2016](#)

Frank Maher will be chairing the annual conference and Sue Mawdsley will be speaking on money laundering, terrorist finance and sanctions.

For further information on any of the above, please Contact info@legalrisk.co.uk

Internal audit: the linchpin of compliance

The PricewaterhouseCoopers Annual Law Firms' Survey 2016 reported 'an increased number of firms with an internal audit function, up to 56% in 2016'. The 2015 survey had observed that 'internal audit remains an area of underinvestment, particularly when benchmarked against corporate businesses of equivalent size, complexity and geographic reach'.

However, the 2016 survey also noted that 'the focus of these functions remains fairly narrowly limited to financial and compliance risks. In our view, internal audit remains an under-resourced function in law firms, with the annual budget on internal audit processes being well below the UK general benchmark of 0.05% of revenues'.

We assist firms with their internal audit. It is a constituent part of the 'Three Lines of Defence' model endorsed by the Institute of Internal Auditors and the Institute of Directors. We also assist in cases where things have gone wrong, for example investigations after discovery of a rogue partner or employee.

The main focus of this newsletter is on some of the areas where internal audit may be critical.

Financial crime

The HM Treasury [consultation paper](#) on the transposition of the Fourth EU Money Laundering Directive into UK national law asks whether there should be a threshold above which firms must appoint a compliance officer, screen employees and have an internal audit function. Firms should also undertake a risk assessment before the Directive comes into effect (which will be by 26 June 2017) and we have assisted many firms in this process.

We advise many law firms and property professionals, including leading City law firms, on technical anti-money laundering (AML) issues, including reporting, privilege, production orders, and whether they can carry on acting, as well as audit, policies, and training.

While on the subject of AML, weaknesses in the UK beneficial ownership data have been identified by Global Witness. See [here](#).

Procurement fraud is not unknown in law firms. We are aware of issues over IT contracts and dealings with lawyers in higher-risk jurisdictions. Section 7 of the Bribery Act 2010 create an offence of failure to prevent bribery. Without a system of internal audit, it may be difficult to establish the 'adequate procedures' defence. A similar provision is now proposed in the Criminal Finances Bill, for failure to prevent fraud.

Very many firms, including a high proportion of City firms, have experienced a rogue partner or employee at some time in their history. If the provision is enacted, then in future the firm may be exposed to criminal penalties if it cannot establish an 'adequate procedures' defence. We advise many firms and their management liability and professional indemnity insurers on rogue partner and employee issues, covering investigations, SRA representation, and partnership and LLP disputes.

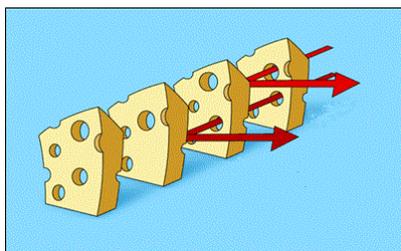
Professional indemnity insurance

Proposal forms may contain representations that firms carry out file reviews. Incorrect responses may lead to coverage disputes, and we are currently advising on one where this is an issue.

This is an area where the landscape may change to the detriment of law firms and claimants, if the SRA's forthcoming consultation on the scope and limits of compulsory insurance result in change. We advise many lawyers on policy coverage disputes where a reduction in the scope of cover would have serious impact. This is not a plea to protect the guilty – innocent clients, partners, former partners and staff may suffer too.

In anticipation of the consultation, the SRA recently published [claims data collected from insurers](#) over a ten year period. As practitioners, not commentators, we shall reserve our comments on these pages for our response to the consultation when it is published in due course.

Meanwhile, we assist firms with their audit and file review processes as well as hands-on assistance in undertaking the reviews. Solicitors in larger firms often express the view that the process would not be practicable or useful: we have demonstrated that the contrary is true.



The Swiss cheese model: Internal audit protects you from failure of your systems



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Note

This newsletter is a general guide. It is not a substitute for professional advice which takes account of your specific circumstances and any changes in the law and practice.

Subjects covered change constantly and develop.

No responsibility can be accepted by the firm or the author for any loss occasioned by any person acting or refraining from acting on the basis of this.

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SRA

Outcome (7.8) of the SRA Code of Conduct requires that 'you have a system for supervising clients' matters, to include the regular checking of the quality of work by suitably competent and experienced people'. Rule 8 of the SRA Authorisation Rules 2011 requires firms to have suitable arrangements for compliance. Guidance note (iii) contains a list of considerations for assessing the adequacy of those arrangements, and these include file reviews.

We represent many firms, including some of the most respected, who are subject to SRA forensic and other conduct investigations. A common issue where something has gone wrong is being able to demonstrate that it happened despite the adequacy of the firm's systems. Internal audit is therefore an important line of defence, which may reduce the impact of an SRA investigation, or enable the firm or individuals to avoid sanction.

Perhaps more importantly, it may also provide early indicators of potential breaches. An example where our audit helped a firm avoid a breach, was in relation to a potential breach of rule 14.5 of the SRA Accounts Rules 2011, the prohibition on providing banking facilities, for which a number of firms have faced disciplinary action, one of the most recent cases resulting in fines on three partners in a City firm: this is not just a small firm problem in our experience.

Client requirements

Clients increasingly drive law firms' risk and compliance requirements, as is apparent from the research paper Independence, Representation and Risk produced for the Solicitors Regulation Authority by Claire Coe Smith and Dr Stephen Vaughan. In part, this is through Outside Counsel Guidelines and Service Level Agreements, with challenges posed, for example, by wide definitions of conflicts. However, a further development is the requirement in public sector tenders for accreditation to quality standards such as ISO 9001, or equivalence, which may create a need for external audit, without which the firm may be ineligible even to tender.

General Data Protection Regulation (GDPR)

There is no real doubt that the requirements of the GDPR will take effect in UK law, regardless of Brexit timings. The UK will in any event have to achieve equivalence status in order to do business with Europe post-Brexit (though the timing of it achieving that status could result in disruption after the expiry of the two year period under Article 50).

The Information Commissioner's publication, [Preparing for the General Data Protection Regulation](#) (GDPR): 12 steps to take now, advises: 'You should document what personal data you hold, where it came from and who you share it with. You may need to organise an information audit, across the organisation, or within particular business areas.'

The new accountability principle in Article 5(2) of the GDPR requires firms to demonstrate that they comply with the principles. Guidance from the Information Commissioner says that the steps firms must take include: 'Implement appropriate technical and organisational measures that ensure and demonstrate that you comply. This may include internal data protection policies such as staff training, internal audits of processing activities, and reviews of internal HR policies.'

We advise on data protection issues. There has been an increase in the use of data protection legislation and subject access requests in connection with professional liability claims, partnership and LLP disputes, and insurers and others investigating fraud. Some of it is appropriate, and some is not: we provide advice to firms on dealing with these requests.

And finally...

Prevention is better than cure. Audit is part of the process for keeping out of trouble, but many of the issues on which we represent and advise lawyers and their firms arise where someone has had an ethics bypass. The first section of the SRA Statement of solicitor competence focuses on Ethics, professionalism and judgement. Ethics training has long been a core requirement for US lawyers and UK firms are now turning their attention to this. It is an area where we can provide training, critically, by practising lawyers.