

■ OFR: the experience of the Financial Services Authority

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Five years ago, the Financial Services Authority (FSA) began implementation of 'principles-based' regulation – the forerunner of outcomes-focused regulation (OFR)

The Solicitors Regulation Authority (SRA) has made clear its intention to adopt OFR when the Legal Services Act 2007 (LSA) goes live on 6 October 2011. In doing so, it is following the path pioneered by the FSA, which five years ago adopted what it then called a 'principles-based' approach to regulation, before progressing to the terminology that it now shares with the SRA. The intention in both cases is to provide a framework within which firms of all shapes and sizes can determine the approach to the compliant conduct of business that best suits their own business model, within parameters defined by the regulator.

It is no coincidence that the new director of regulation at the SRA was recruited from the FSA. Despite its failings in relation to prudential supervision, the FSA now appears to be regarded as the template regulator of professional services.

Introducing flexibility

When the FSA became the sole regulator of financial services in December 2001, it introduced a rule book of 40,000 pages which, with the pace of developments in the industry, needed updating almost before the ink had dried. Those conscientious compliance managers who had purchased the nine thick ring-binders containing the hard copies of the rules relating to their particular business sector became inundated with replacement pages and smaller organisations floundered. The conclusion was soon reached that providing codified regulation for disparate businesses in a fast-moving commercial environment was impractical and a more flexible approach had to be devised.

Similarly, the solicitors' rulebook has already been reduced in size, and the SRA is now faced with the task of producing in an even more compact document a set of rules appropriate not only for traditional solicitors' practices but also for providers of legal services that may be owned and managed by almost anyone who has not blotted his or her regulatory copybook. It is no surprise, then, that it has turned to the FSA for inspiration.

The downside of introducing flexibility is that it is necessarily accompanied by subjectivity, which, to make matters worse, is often exercised retrospectively. The absence of certainty is anathema to many lawyers, though they have of course had to live with this in the past, notably when considering the judgments of Lord Denning. Tax lawyers are equally having to operate within a regime that confers a degree of subjectivity on Her Majesty's Revenue and Customs that relies heavily on the processes of the democratic system for the protection of taxpayers and their advisers against abuse.

Outcomes-focused regulation also spills over inevitably into quality standards, and it is here that the starting point of the SRA differs from that of the FSA.

Putting the client first

To provide the framework within which its principles-based regulation can operate effectively, the FSA created, alongside its rulebook, a rigorous set of operational demands, which it promotes under the somewhat misleading slogan of 'treating customers fairly' (TCF), but which in reality constitute practice management standards whose underlying assumption is that any inefficiency may potentially be prejudicial to the interests of the client. The existence of TCF has enabled the FSA effectively to snub the new quality standard for financial services, ISO22222, and to abandon its own earlier proposal for the establishment of a Professional Standards Board.

Solicitors have their own quality and practice management standard in the form of Lexcel, but there are several differences between Lexcel and TCF. First, Lexcel accreditation is optional and has, as yet, been pursued by only 850 firms, though there are plans to increase this number. Secondly, Lexcel has tended to concentrate on internal issues, such as human resources, client care, complaints and diversity, whereas TCF deals also with the outward-looking issues of business management and development. Thirdly, Lexcel is administered by the Law Society rather than the SRA and does not, therefore, form part of the regulatory regime.

Arguably, in the context of the legal profession, practice management support is more suitably provided by a representative body, rather than being enforced by a regulator. The profession does not suffer from the mischief that TCF was originally designed to address, namely the mis-selling scandals that afflicted the financial adviser community in the 1990s and were attributed to firms having placed their own interests above those of their clients. Indeed, the response of many law firm compliance partners of FSA-authorized law firms, on receiving a phone call from the FSA on the subject of TCF, has been an indignant protest 'of course we treat clients fairly: we are solicitors' – a response that has, in a number of cases, prompted the involvement of the FSA's enforcement team.

Financial advisers originally regarded TCF as yet another unwelcome regulatory burden, and it has been a pleasant surprise to many that their businesses have benefited substantially from its adoption. It has enabled them to abandon their cottage-industry beginnings and to face up to the era of fee-based advice and advanced qualifications that is currently being ushered in by the FSA.

Many solicitors are faced with the need to make a similar transition if they are to compete successfully against the commercial competition that will be unleashed on the profession by the LSA, and the need for improved business management is clear. In the words of the Law Management Section's 2009 report entitled 'Achieving growth through merger, acquisition and organic growth': 'Perhaps the main requirement for all of these [ABS] options will be good and well

developed management and skills only found in a minority of firms at present.' Making the same point, Jeremy Hand of private equity house Lyceum Capital Partners commented in *The Lawyer* of 9 August 2010: 'You need management, clear strategy, capital and sound execution. I'm not sure how many traditional [law] firms offer this combination.'

So, what exactly is TCF, and how can solicitors benefit from the adoption of TCF processes?

The explanatory note on the FSA website reads:

'We are focusing our more intrusive approach on "conduct of business" risks just as much as on prudential risks. We have strengthened our focus on conduct risks, with a new Conduct Risk Division to identify and mitigate conduct risks and to support our assessment of TCF as part of our core supervisory processes. We aim to do this by proactively focusing on the outcomes firms are delivering for consumers. Our more intrusive supervisory approach means we will be ready to make more judgements about the quality of consumer outcomes.'

Emphasising the fact that TCF is an ongoing requirement, subject to regular review and updating, the FSA goes on to say: 'TCF should become an integral part of firms' business culture – a continuous process, not something that firms can implement and forget.'

Client communications are an area where many solicitors have a blind-spot

Choosing the right people

The starting point for both the FSA and the SRA is that regulation relates primarily to firms rather than individuals, and that it is the responsibility of firms' management to ensure compliance. The FSA defines the key management roles as 'controlled functions', a principle that is again being carried forward into the SRA regime. In the case of the FSA, the controlled functions are the 'governing' function of director or board or partners; the required functions of compliance oversight and money laundering reporting; and the customer functions relating to client-facing activities. In the case of the SRA, there will be a requirement for law firms to appoint a compliance officer for legal practice (CoLP) and a compliance officer for finance and administration (CoFA), while the 2007 Act requires ABSs to appoint a head of legal practice (HoLP) and head of finance and administration (HoFA).

The significance of all these roles is that the incumbents are expected to have authority within their firms which complements their responsibility to the regulator – a development that should be of immense value to solicitors in enabling firms to address the 'confederation of sole practitioners' syndrome, whereby in many cases individual partners have been reluctant to fall in line with any attempt at central co-ordination.

In the FSA's book, the initial responsibility of management is to lay down business plans and define an organisational structure, and to ensure that both are kept under constant review and are updated as appropriate. In his speech to the

2009 SRA Regulation Conference, Professor Stephen Mayson suggested that only 30 out of the top 100 UK law firms had a proper business plan.

Getting the message across

Both the plan and the organisational structure need to be communicated to colleagues and staff, and a two-way flow of information is to be encouraged, with provision for staff meetings whose minutes record discussion of matters such as management decisions, current business levels, market factors, resources, training, and ideas for improving client care and business development. The importance attached by the FSA to internal communications is reflected in the following comment from a report recently issued to an accountancy-based independent financial adviser firm, following a routine TCF visit:

'Your firm has very clear communication channels and processes to ensure that all the staff are made fully aware of any changes within the firm. The fair treatment of customers is discussed at your firm's board meetings, adviser meetings and administration meetings with comments/information being fed up and fed down from these meetings.'

Another key responsibility of management, which is on the agenda of both the FSA and the SRA, is to ensure consistency of business processes within the firm and procedures that permit standards to be monitored internally, so that individuals who have been wont to embark on frolics of their own are reined in. The same report from the FSA continued:

'Your firm's process for reviewing the advisers' files helps to ensure that any areas of concern are resolved immediately. Any issues are also fed into the advisers' reviews and action plans are put in place if any trends are identified.'

Client communications are also important, and this is an area where many solicitors have an unfortunate blind-spot. How many private client lawyers, for example, thought to circulate to clients for whom they had drafted nil-rate band wills, advising them of the possible impact of the 2008 changes in the tax regime? Keeping in touch with clients is vital if relationships are to be maintained, and there is a salutary warning in the 2009 survey by the Legal Services Board (LSB), which found that most of the recent consumers of legal services interviewed at random would not go back to the same solicitor for subsequent advice because they did not consider that an ongoing relationship existed.

Regular client communications also tend to reduce the risk of complaints. It is the clients who feel abandoned who are most likely to complain; and if they do complain, it is not enough simply to ensure compliance with the complaints procedure. TCF demands that firms should be seen to have investigated the cause of the complaint and determined how best a repetition might be prevented.

Was the complaint a reflection on the firm or the adviser? If the firm, what action should be taken? If the individual, did this reflect on competence or client-care standards or lack of supervision? And do the answers to these questions suggest disciplinary action or further training or a redefinition of roles? And what action might be required in respect of advisers' personal development plans and key performance indicators? And do these impact on the firm's business plan? On all these questions, the maintenance of an audit trail is considered vital.

Assessing the risk

A noticeable difference in the approach adopted by the FSA and the SRA in relation to risk is that, whereas the FSA's pre-occupation is with risk to the client, the SRA's 2010 consultation papers make clear that its main concern is with risk to the solicitor. This point may have been picked up by the LSB Consumer Panel, which commented in its response to the consultations:

'The SRA should consider an approach, akin to Treating Customers Fairly in financial services, where a small number of key consumer outcomes, firmly rooted in the client experience, lie at the heart of the regulatory framework.'

Collecting information

Client surveys are an important element in the management information that the FSA insists that firms should collect and analyse. The results complement the comprehensive data that firms are required to record in respect of their clients via the 'know your client' process, which is a mandatory requirement before any advice is provided.

Again, there are lessons to be learnt from the FSA experience. Few law firms have a firm-wide client database and most IT systems for lawyers concentrate on 'matters' rather than clients. As a result, the mentality of client ownership by individual partners is perpetuated and team ethos is inhibited – an issue to which reference was made in the Lexcel section of the Law Society's Law Management Section's Human Resources Toolkit of 2009:

'One of the challenges that practices can experience is the protectiveness that partners or client-facing staff can feel towards their clients. This reluctance may stem from the understandable concern of not knowing the quality of client service or processes used by a colleague.'

Analysing client information also enables firms to assess the profitability of individual clients or categories of client and to decide where best to concentrate their efforts. A useful approach is to segment clients by reference, for example, to profitability, wealth, age group or location. Combining the resulting information with statistics such as the increase or decrease in demand for given services might cause firms to re-focus their services or perhaps to slim down their client base and major on the business areas in which they enjoy a competitive edge. It is often found that some clients are subsidising others.

Managing efficiently

An indication that the SRA is minded to adopt a similar approach to the FSA in equating regulatory compliance to the adoption of efficient business management techniques was provided in its consultation paper of 28 May 2010, which stated: 'A key element of our supervisory approach will be on assessing firms' management and decision-making systems.'

The SRA also made clear its intention to employ a similar supervisory process to the FSA's, involving seminars, thematic phone calls and visits, consumer surveys and the requirement for annual reports from regulated firms.

Asking the right questions

Constant self-questioning makes for perfection, and the FSA goes far beyond demanding that management should analyse

financial and business information. Every decision that could impact on the firm's efficiency needs to be subjected to a due diligence process, in the same way as the criteria recently approved by Lexcel for the selection of financial advisers by solicitors. A tool recommended to firms by the FSA is 'gap analysis', which requires firms to play devil's advocate and to test the robustness of their own systems, with questions such as:

- Has the firm issued job descriptions and promulgated an organisation chart?
- Is the firm's business plan being reviewed regularly?
- Does the firm have a documented policy on the use of IT systems?
- Has the firm adopted and implemented written policies for human resources, client care, training and competence, compliance, money laundering and complaints, and are these reviewed regularly?
- Do the firm's procedures identify and provide for higher-risk activities?
- Does the firm commission independent advice on its planning and procedures?
- Are the firm's procedures reviewed regularly to ensure that they take account of regulatory and market developments?
- Are clients provided with an intelligible explanation of the firm's services?
- How does the firm gauge the effectiveness of fee-earner training?
- Does the compliance officer provide a regular written report to management?
- Is provision made for staff meetings and for the consideration of the minutes of staff meetings by management?
- Do members of the firm have qualifications appropriate to their specialisations?
- Does the firm conduct regular client satisfaction surveys?
- Is the firm's website compliant?

Both the FSA and SRA make clear that the regulatory dividend is that firms that conduct their affairs efficiently and with integrity can expect a lighter touch from the regulator. However, there is also a clear financial dividend for the proprietors of and participants in efficient businesses.

The limitations of the traditional approach to practice management standards have already been exposed by high-profile law firm failure, and Mark Jones of Addleshaw Goddard was reported in the *Law Society Gazette* ([2010] 30 September 'Five firms "put in intensive care" by banks') as predicting that more failures are likely to occur as the profession emerges from the recession. Looking more optimistically to the future, however, outcomes-focused regulation offers firms the opportunity to adopt client-centric management practices that will enable them to regain their historic role as trusted advisers, establishing ongoing client relationships based on confidence and respect.

As the then current Law Society President Paul Marsh commented in his foreword to SIFA's *Financial Services for Solicitors* (Law Society, 2009): 'Today we are not just solicitors, we are all business people.'

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