



The Law Society

Exercising the statutory power to pay the cost of firm interventions from the Compensation Fund

Law Society response

May 2013



Introduction

We are pleased to take this opportunity to respond to the SRA's consultation.

- We recognise that to pay the unbudgeted costs of interventions in 2013 using the Compensation Fund is preferable to a levy on the profession.
- We believe that every effort should be made to reduce the overspend and thus the charge to the Compensation Fund by directing the maximum amount of SRA discretionary spending in the current year revenue budgets to offset this overspend.
- The process of intervention is just one of a number of methods by which the SRA enforces compliance and the internal and administrative costs should, in principle, form part of its budget. This helps to ensure that there is transparency and accountability.
- The Compensation Fund exists primarily to make good any deficiency in client money and to maintain public protection in the event of solicitor dishonesty; this does not necessarily align with the purposes for which intervention costs may be incurred. There is significant value in keeping the cost of 'last resort' compensation and the cost of enforcement separate.

The SRA needs to:

- carry out more work on avoiding the need to intervene and the associated costs;
- when interventions arise, manage the process efficiently and economically. For this reason, the costs should remain in its budget and accounts; and
- undertake a full and detailed impact assessment of its proposals which we consider to be an important part of any consultation on change and essential in this case.

By way of overall observation, we consider that there needs to be improved transparency and accounting for the Compensation Fund and we wish to work with the SRA on this. We also wish to work with the SRA to consider alternatives to intervention, particularly in the situation of financial instability of a firm.

The immediate proposals

Subject to the points above, the Law Society understands the need for emergency measures to fund the increased cost of interventions for 2013. However, it does not support the adoption of this policy for future years. Emergency measures should not be used to drive a policy change prior to the SRA's full review of the entire compensation arrangements. We understand this to be scheduled for 2014.

Before any long term policy change is implemented, the SRA needs to undertake a full impact assessment of its proposal. It also needs to ensure that there is proper accountability for the level of resources expended on interventions. This requires that sufficient incentives are in place for the SRA to budget for such costs and that interventions are only used in the extraordinary situations when no other remedy is suitable or available. In our view, the SRA should make provision for estimated intervention costs within its budget (funded via PC fee) and only in the event of unexpected increases in these costs apply to the Compensation Fund as an emergency funding measure.

The purpose of the Compensation Fund

The risk in using the Compensation Fund to pay for interventions is that it muddles the purpose of that Fund and requires new and additional mechanisms for its efficient management. The Fund exists to provide compensation as a means of last resort in appropriate cases for consumers who have lost money because of failure to account by or dishonesty of a solicitor. By its nature the money that the Fund will pay out in any year may be less predictable than for carrying on the SRA's regulatory activities. The Fund may well be called upon following regulatory activity, such as interventions, however, it performs a separate function from the role of regulating the profession.

Interventions should be one of a number of appropriate and proportionate measures for regulating firms. There should be an incentive on the SRA to budget for these costs within the PC fee setting process and the SRA's balance sheet. As a risk based regulator, the SRA should be able to identify firms at risk of posing a threat to client loss, assess the likelihood of intervention and to budget for these costs. While some costs will still need to be estimated as part of setting the Compensation Fund levy, maintaining intervention costs within the SRA's Budget will ensure there is sufficient accountability for the regulator to have the incentive to ensure an efficient approach to the intervention process. It will also place the funding for these activities where it belongs – with the regulator making the choice about which of its regulatory functions to use in particular cases.

The intervention process

Intervention is a draconian measure with severe impacts and costs for all concerned; it may impact on a large number of 'innocent' parties, including clients and employees. It should only be necessary in a small number of cases. Given the costs and the impact on those involved, interventions should be avoided where possible. We welcome the work that the SRA has undertaken to identify 'problem' firms early and work with them to encourage and bring about an orderly closedown.

The Law Society considers that there are alternatives to intervention that could cut costs further and improve outcomes. These include:

- the appointment of a client account manager to ensure client funds are protected while a firm is wound down; and
- improving the tendering process for external agencies (e.g. intervention agents and those involved in file retention and storage) and the terms upon which they provide services related to interventions.

Further work is needed to find the appropriate regulatory response to the new phenomenon where a firm fails for purely financial reasons. In these situations, it is often preferable for the SRA to work with the firm's administrators, and, if all parties agree on the appropriate course of action, act as a facilitator, rather than threatening intervention or becoming directly involved in the process. We would welcome the opportunity to work with the SRA to further develop its policy on alternatives to interventions.

What is essential, however, is that there should be proper accountability for the costs incurred before, during and post intervention so that the process is transparent. This enables lessons to be learned from failures in forecasting risk, managing supervision and provides an evidential basis to assess options for the future.

Impact assessment and accountability for the Fund

While we recognise the need for emergency funding to cover the 2013 shortfall, it is not appropriate to implement a fundamental policy change without undertaking a robust impact assessment. The SRA's consultation paper fails to set out the likely impact of the change for future years. Although the level of interventions may be difficult to estimate at present, this is no different from much of the regulatory activity undertaken by SRA. The SRA's increased focus on the financial stability of firms is likely to assist this risk assessment process and provide a platform for future forecasts.

Long-term policy change should be accompanied by forecasts about the likely impact that changes will have on individual and firm contributions to the PC and Compensation Fund. The SRA's conclusion regarding its inability to calculate firm fees due to the difference in formulae is unacceptable. As a regulator, the SRA should understand and assess the impact of its proposals on different segments of the profession and clearly set out these impacts as part of any consultation proposing a fundamental policy change.

We also believe that the cost/benefit assessment of a transfer of the full costs of interventions onto the Compensation Fund must also consider all of the other costs that the Compensation Fund may potentially have to bear, now and in the future. The scope of the Compensation Fund has been considerably expanded in recent years and now includes:

1. Payment of expenses for protecting the fund
2. Administration costs for the fund
3. Intervention costs
4. Payment of claims for dishonesty, fraud and failure of account
5. Cover for uninsured firms (transfer of the non-applied firm role from the Assigned Risks Pool (ARP) from 2012)
6. Payment of claims under policies that have been cancelled due to insurer insolvency (eg Lemma run-off claims), and
7. The potential for the level of uninsured firms to increase due to failure to effectively manage the Extended Endemnity Period/Cessation Period (EIP/CP).

The SRA has not considered any potential increase to the costs of the Compensation Fund as a result of these increased functions or the financial impact on the profession. Furthermore, there is no order of priority for payment of these costs. The SRA should develop a coherent policy, as part of its 2014 review, about which costs should receive priority in the event of competing claims on the resources of the Fund.

The Law Society is concerned about the new risk for increased claims on the Compensation Fund due to any failure by the SRA to effectively regulate the new EIP/CP arrangements. The 2013 draft SRA Indemnity Insurance Rules (SIIR) and Participating Insurers Agreement (PIA) rely on self-reporting by firms as the SRA's only means of identifying which firms enter into the EIP/CP and are therefore to cease to practice within 90 days.

Insurers are only required to report quarterly to the SRA; the Law Society's position is that insurers should have reciprocal reporting arrangements so that the SRA can cross-check insurer information against information received by regulated entities. As the situation currently stands, if a firm does not self-report these events, it will be left to the SRA to identify that a firm's policy has ended and contact each firm to check whether it has obtained insurance. We have always maintained that the EIP/CP requires effective enforcement by the SRA. Unless the SRA learns from the lessons of the 2012 ARP matching exercise and implements an efficient process to monitor these firms, we are concerned about the potential need for interventions arising from regulatory failure.

Accordingly, there is a danger that the Compensation Fund is being used simply as a source of funds to meet an expanding set of emergencies. The Fund, ultimately, is paid for by the profession and the profession is entitled to accountability and transparency for its expenditure.

We support the publication of the Compensation Fund accounts. It will be essential, whether or not interventions are included, for the SRA to publish a robust and detailed report that contains itemisation based on sources of claims and expenditure. We would welcome the opportunity to share further thinking with the SRA on this issue.