Monitoring compliance failures - Where risk meets KM

Developing a knowledge-management strategy to capture and share knowledge is an essential component of effective risk management. Peter Scott, consultant & former managing partner, Eversheds, explains.

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OUTCOMES FOCUSED regulation has introduced not just a new approach to the regulation of law firms; it has imposed requirements on law firms to more formally structure their risk management. That is no bad thing because the requirement to put structures in place to manage risk should force firms to focus on those areas of operation which involve serious risks to their business.

That is not to say that law firms were not effectively managing their risks before outcomes focused regulation – many well run firms were certainly doing so, but it was often on an *ad hoc* and *laissez faire* basis. As the managing partner of a large law firm said to me when discussing the impact on his firm of the new approach to regulation: "We trust our partners in how they run their practices."

That approach is no longer tenable. Risk has to be managed now in a different way. Mandatory Principle 8 from the SRA Handbook requires law firms to "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".

In order for a law firm to effectively manage any form of risk requires it to have knowledge of every aspect of its internal operations and of external factors that may impact on it. As Donald Rumsfeld once famously said: "But there are also unknown unknowns – the ones we don't know we don't know."

Unless knowledge can be adequately managed then a law firm will be at risk. Accordingly, developing a knowledge-management strategy designed to capture and share knowledge for the benefit of the business will need to be an integral part of a law firm's risk-management strategy. How can a law firm gain knowledge of its 'unknown unknowns'?

One of the most effective ways a law firm can gain the essential knowledge it will need to manage its risks will be to observe and test the manner in which it operates and the measures it has put in place to control how those operations are conducted. Of course, this is not just prudent risk management – it is now a compliance obligation, as Outcome O(7.3) in the SRA Code of Conduct requires law firms to: "Identify, monitor and manage risks to compliance with all the Principles, rules and outcomes and other requirements of the Handbook… and take steps to address issues identified." Accordingly, the continuous monitoring, analysis and assessment of risks related to a law firm's operations and business, followed by the monitoring, analysis and measurement of the effectiveness of the responses put in place to reduce or eliminate those risks, should now be a fundamental part of the way in which every law firm manages its business.

An effective way to identify many of the high risk areas in a law firm is to carry out random file reviews on a regular basis, either by partners from another part of the firm or by external reviewers.

Each law firm is likely to develop its own particular ways of monitoring the effectiveness of risk control measures it has put in place. However, there are some particular monitoring techniques that will enable law firms to gain essential knowledge to effectively manage their risks.

File reviews

An effective way to identify many of the high risk areas in a law firm is to carry out random file reviews on a regular basis, either by partners from another part of the firm or by external reviewers. File reviews can provide a law firm with an accurate picture of which people or departments are not following procedures. For example, they can:

- Reveal the extent to which matter and client inception procedures involving conflict of interests checks, anti-money laundering checks and risk assessments are by-passed, enabling files to be opened and clients taken on without these essential risk procedures being carried out;
- Identify failures to deal adequately with engagement letters, the use of which should be an integral part of protecting a firm against claims and complaints. For example, file reviews often show that not only do engagement letters not adequately scope the work to be carried out for a client, or adequately explain how work is to be charged for, but are sometimes not even sent to the client;
- Reveal risk issues relating to the quality of advice provided, lack of supervision, complaints by clients and inadequate record keeping on a file, which can mean a firm may be unable to demonstrate that it is SRA compliant.

The findings revealed by regular file reviews are likely to focus and prioritise a law firm's efforts when considering further measures to reduce risk.

Identifying and assessing compliance risks

Pre-file opening risk assessments

Many, if not most, of the highest risks to law firms arise from taking on work and clients without adequate risk assessments being carried out. Firms have in the past, and many still do, leave control of taking on matters and clients solely to the judgment of their partners. However, experience has shown the judgment of some partners to be less than adequate, particularly in difficult economic times where, for some firms, accepting any kind of work from any client is likely to be attractive.

File reviews, as described earlier, are likely to reveal problems that can arise from a lack of control in assessing risks at the matter and client inception stage. What is required are controls to prevent a matter and a client being taken unless the potential risks associated with such work have been assessed.

Some firms have developed mandatory risk management assessment questionnaires to monitor and assess risks relating to work and clients. These questionnaires have the ability to score responses to indicate the risk level of that work and client, which can then be used to decide how those risks should be managed. File reviews can be used to monitor whether such risk assessments have been effectively carried out and whether the control procedures put in place (for example, enhanced supervision) have been effective.

Positive self-certification of compliance

It is important to create an open, 'no blame' culture to encourage everyone to report problems on a voluntary basis and without recriminations. In practice, this can be difficult to achieve, notwithstanding whistleblowing legislation and policies designed to protect employees.

One way to drive disclosure of compliance failures is for a law firm to require its staff to positively self-certify on a regular basis that they have complied with certain stated procedures relating to, for example, anti-money laundering, conflict checks, file opening risk assessments, engagement letters and the provision of costs information to clients.

Ideally, such self-certifications should be completed online and integrated into the firm's IT systems to make the task of reviewing and demonstrating compliance efficient and cost effective.

Other methods of monitoring compliance

The monitoring techniques mentioned above can be particularly effective in helping firms discover whether their most important risk management procedures are working. There are, of course, a number of other effective approaches:

- **Supervision**. If diligently managed, supervision should effectively monitor the quality of advice and service, and in doing so help raise standards. It is important, however, to ensure that all supervision is recorded so if challenged a firm can demonstrate that it is compliant.
- **Claims and complaints monitoring.** The recording and analysis of claims and complaints made against a firm are a good way to assess whether risks are being effectively managed. In relation to complaints, expressions of dissatisfaction should also be recorded as these are often an early warning indicator of things going wrong.
- **Financial measurement.** Financial measurement in relation to non-financial risks can be very telling.

For example, levels of work in progress and debtors are litmus tests of how effectively partners and fee earners may be managing client relationships.

Systemise your compliance monitoring

Providing the necessary resource to effectively manage compliance and other risks is now a major issue. Cost effective ways to capture knowledge and more efficiently monitor risks should be high on the agenda for all firms. To this end, firms should use IT systems:

- To create and maintain a central, up-to-date compliance and risk database;
- To provide information access to everyone who needs it in relation to exposure to risk and its management;
- To embed into the firm's systems its compliance and other risk management procedures – for example, client inception procedures (mentioned earlier);
- To streamline the identification, recording, assessment, monitoring, reporting and mitigation of compliance and other risks, including exceptions to compliance; and
- To demonstrate to insurers and the SRA that it is effectively managing its risks.

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Obtain senior buy in

The close monitoring of how people operate in a law firm is likely to be regarded by some as a 'big brother' environment. However, unless everyone in a firm follows procedures, then a firm is likely to be at risk.

A 'zero tolerance' approach that does not permit exceptions is required. This will need top-level buy-in. Firms should also consider incorporating into their governance arrangements provisions, such as:

- All partners to comply with all regulatory requirements – with sanctions if they do not;
- The COLP and COFA to be provided with full access to all information and to have the right to take independent advice at the firm's expense in the event of disputes;
- Indemnities to be provided to the COLP and COFA in respect of penalties costs and expenses if they are prevented from properly carrying out their responsibilities; and
- The firm to pay premiums for appropriate insurance policies for the COLP and COFA.

Implementing a more structured approach to monitoring risks will help law firms focus on the key compliance issues. However, the effective management of risk for the purposes of outcomes focused regulation requires a 'mindset' change for all staff and fee earners within a firm. The continuous monitoring of compliance and other risks, whereby effective risk management becomes part of everyone's day-to-day work, should help bring about this change. ■