Financial penalties

A report for the Solicitors Regulation Authority

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Economic Insight Ltd

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1 Summary

1.1 The SRA has asked Economic Insight to provide:

a. An analysis of the advantages and disadvantages of the different metrics the SRA could use to take account of the means of the individual with recommendations for the best way forward.

b. An analysis of the advantages and disadvantages of the different metrics the SRA could use to take account of the means of firms along with recommendations for the best way forward.

c. An analysis of how increasing our maximum threshold from 2.5% to 5.0% in relation to different metrics the SRA might use may impact firms of different sizes.

1.2 In reaching our conclusions, we have sought to identify the approaches that we consider are most likely to meet the SRA's objectives of ensuring that its financial penalties are proportionate to the means of the individual or firm and that they will act as a credible deterrent. (We note here that these objectives go hand-in-hand – that is, if firms or individuals were unable to pay the fines imposed by the SRA, then the fines would not act as a credible deterrent.)

1A. Metrics for assessing means and calculating financial penalties

1.3 Our conclusion is that turnover (in the case of firms) and income (in the case of individuals) are likely to be the most appropriate metrics for assessing means and the basis upon which the SRA's financial penalties are calculated. This is consistent with the approach that most other regulators adopt.

1.4 In reaching this conclusion we have considered the advantages and disadvantages of different metrics in terms of their ability to support the SRA's objectives "in principle" and also the ease with which they could be used "in practice".

1.5 In particular, we have carefully considered the extent to which using accounting measures of firm profit, rather than turnover, would better meet the SRA's objectives. Our conclusion is that using accounting measures of firm profit are likely to create material practical challenges and, as such, are unlikely to better meet the SRA's objectives.

- One example of a practical challenge is that different firms may adopt different (legitimate) methods for accounting for the costs that they incur. For example, one firm may depreciate (spread) the cost of its IT equipment over 5 years, whereas another may depreciate the same cost over 3 years. The first firm could appear more profitable than the second firm, even if it earned the same revenues and incurred the same IT costs.

- Another example is that different firms may adopt different remuneration models. For example, a partner could be remunerated by way of a salary or a profit share or both. Remuneration by salary would be recorded as a cost in the firm's accounts, whereas a profit share would not. Therefore, one firm could appear less profitable than another simply because it has adopted a salary-based remuneration model, not because it is less profitable in any meaningful sense. Indeed, a firm may report zero accounting profits due to paying one-off bonuses to its partners and/or other staff members.

1.6 The examples set out above illustrate that the use of accounting measures of profit may not better correlate with means than turnover. This is because they can be affected by the way a firm accounts for its costs, the remuneration model it adopts and other financial decisions that may be entirely unrelated to its ability to pay a fine or the financial viability of its business.

1.7 In theory, it would be possible for the SRA to issue detailed guidance on how it would propose to measure a firm's profitability for the purpose of assessing its means and calculating its fines, and in doing so, go some way to overcome these challenges.

1.8 However, in practice, it would likely be difficult to anticipate all possible eventualities, and so the SRA would ultimately need to exercise its regulatory discretion when determining means and calculating fines. This would reduce the (ex-ante) clarity that the SRA could give regulated firms about how it will determine means and how it will calculate fines. Thus, there is a risk that this reduction in clarity would reduce the deterrent effect of the fines and thus compromise the SRA's ability to meet one of its objectives.

1.9 We reach similar conclusions in relation to the use of other metrics, such as current assets (e.g. cash).

1.10 The use of turnover – although it is not without practical challenges (which mainly arise due to the need to specify the product/service and temporal scope of revenues to include or exclude from the calculation of turnover) – has less pronounced challenges than the use of accounting measures of profit. This is because the measurement of turnover is, by definition, unaffected by the cost-related issues set out above.

1.11 Similar considerations point towards the use of income for individuals. Other metrics, such as net worth, can be greatly affected by how and when an individual's assets are valued and may not reflect their means if they cannot be sold or borrowed against.

1B. Increasing the maximum fine level from 2.5% to 5.0% of the relevant metric

1.12 Other things equal, an increase in the maximum fine percentage from 2.5% to 5.0% of turnover will increase the deterrent effect of the fine. In doing so it could affect firms via two routes:

a. Whether or not they are ultimately fined, it could encourage more firms to take further steps to mitigate the risk of incurring a fine (because the costs associated with those steps are more likely to be offset by the expected benefit of taking them, i.e. the avoidance of a higher fine).

b. If a firm is fined, it may have to pay a higher fine than it would otherwise have done.

1.13 The extent to which these effects will materialise in practice depends on various factors, including the extent to which the maximum level of the fine influences firm behaviour. This in turn will depend on the perceived risk of being fined at the maximum level, which in turn will depend on the SRA's historic enforcement behaviour (i.e. the number of fines it imposes at the maximum level).

1.14 Regarding the first route (a), *a priori,* there is no reason to expect that this route would affect the viability of firms in general, or disproportionately affect smaller firms more or less than larger firms. This is because all firms are exposed to the increase in the (potential) maximum fine, which is proportionate to their revenue. It follows that the "playing field" is not tilted in favour of one firm over another in a manner that would cause one firm to have to absorb the costs associated with mitigating the risk of incurring a fine (thus reducing its profitability) to remain competitive with other firms.

1.15 Regarding the second route (b), *a priori*, there is no reason to expect that this route would disproportionately affect smaller firms more or less than larger law firms. Again, this is because the fine is proportionate to revenue.

1.16 The only question is whether levying a fine of 5.0% would compromise the viability of any given firm, irrespective of its size, whereas levying a fine of 2.5% would not.

1.17 Increasing the fine from 2.5% to 5.0% could compromise a firm's viability if it:

– does not earn sufficient profit to pay the fine (i.e. earns a profit margin of more than 2.5%, but less than 5.0%);

- cannot use reserves or gain access to other sources of finance to pay the fine;
- cannot make other cost savings to pay the fine; and
- cannot spread the fine over more than one year (e.g. retaining profit over several years in anticipation of paying the fine and/or spreading the payment of the fine over several years).

1.18 Again, there is no *a priori* reason to expect that these circumstances are likely to arise in practice, but we recognise that the answer to this question will ultimately depend on the financial position of the firms that are fined (and so cannot be easily informed by understanding the financial position of firms "on average").

1.19 Finally, we note that:

- the 5% figure is line with – or rather slightly below – the maximum fines levied by other regulators;
- the SRA's approach to fining (beyond the maximum level of the fine) can influence a firm's ability to pay the fine, e.g. in terms the amount of prior notice that the SRA gives a firm and the amount of time that it gives the firm to pay it.

1C. Structure of this note

1.20 The remainder of this note sets out our more detailed considerations to arrive at the above recommendations. Specifically:

- Chapter 2 considers what metrics best reflect the means of firms.
- Chapter 3 appraises what metrics best reflect the means of individuals.
- Chapter 4 assesses the impacts of increasing the maximum fine level from 2.5% to 5.0%.

2 Taking into account means of firms

2A. Rationale for considering firms' means

2.1 The SRA imposes financial penalties to both: (i) sanction a regulated firm or individual for a serious breach of its standards/requirements;[1] and (ii) deter the firm or individual (and others) from similar behaviour in future.[2]

2.2 For the penalty to credibly act as a sanction and a deterrent, the regulated firms and/or individuals who have committed a serious breach need to be able to afford to pay the financial penalty. Therefore, the SRA needs to be able to assess whether both firms and individuals have the means to pay the fines.

2.3 Currently, the SRA considers firms to be of 'greater means' if they have an annual domestic turnover of £2 million or over. Where firms are of 'greater means', the financial penalty is a percentage of up to 2.5% of the firm's turnover. Where firms are not deemed to be of greater means, they are penalised across bands with fixed penalty charges.

2.4 Although responses to the SRA's consultation on financial penalties[3] generally supported proposals to take into account the means of firms when setting a financial penalty, some stakeholders raised concerns about the right metrics to use.

2.5 Specifically, some stakeholders questioned whether:

- the turnover of a firm is a reliable indicator of its financial position, profitability, and the availability of cash; and
- any lag between last reported turnover and disciplinary proceedings means the SRA is not considering an accurate picture.

2.6 Below we first consider the merits of using different metrics to turnover, followed by considering what the appropriate scope of the relevant metric is (i.e. in terms of what activities are included and what time-frame ought to be considered for setting the financial penalty).

2B. Considering different metrics to turnover

2.7 Other potential metrics than *turnover* to consider firms' means include:

- *profit* (e.g. return on capital employed, earnings before interest and tax, gross profit, etc.);

[1] *But where protection of the public/public interest does not require suspension or a striking off or its equivalent.*
[2] *See: https://www.sra.org.uk/solicitors/guidance/financial-penalties/*
[3] *See: https://www.sra.org.uk/sra/consultations/consultation-listing/financial-penalties-2021/*

- *capital employed* (e.g. the value of tangible assets such as buildings, the value of intangible assets such as brand); and
- *current assets* (e.g. cash).

2.8 Depending on how each of these potential alternative metrics is defined, they are intertwined (to a degree). For example, if profitability is defined as 'return on capital employed', capital employed is by definition part of the profitability metric. Similarly, to measure 'capital employed', one must have a view on what current assets are:

- **Profitability** metrics will necessarily be netting off any costs incurred from *turnover*. For example, *earnings before interest and tax* (*EBIT*) net off *operating costs* and *depreciation* and *amortisation* from *turnover*. In turn, *return on capital employed* is defined as *EBIT* over *capital employed*, which is *total assets* less *current liabilities*.

- **Capital employed** is based on both tangible and intangible assets, as well as a firm's current liabilities.

- **Current assets** will face the same issues as tangible and intangible assets set out under capital employed above, as they are one element of (tangible assets) deriving that metric.

2.9 Thus, it is not clear from the outset whether **profit** would better correlate with a firms' means compared to turnover. This is because profits can be high or low for several practical reasons, and thus turnover is a more consistent measure:

- **Different firms may adopt different (legitimate) methods for accounting for the costs that they incur**. For example:
  - **In relation to depreciation of fixed assets** one firm may depreciate (spread) the cost of its IT equipment over 5 years, whereas another may depreciate the same cost over 3 years. The first firm could appear more profitable than the second firm, even if it earned the same revenues and incurred the same IT costs.

   - **In relation to ownership of fixed assets** one firm could choose to purchase its office building and thus have mortgage repayments to honour (which would be included in its financial statements as interest), whereas another frim could choose to lease its office from a third party (which would be recorded as an operating expense). Depending on the specific profit metric chosen, one firm may appear less profitable purely by the way it chose to finance its office building ownership. For example, the firm that chose to finance it through operating leases (that are included in operating costs) would appear to have lower profits, compared to the firm that chose to finance it through mortgage interest payments, which are considered interest expenses, and thus would not reduce its profits.[4]

- **Different firms may adopt different remuneration models**. For example, a partner could be remunerated by way of a salary or a profit share or both. Remuneration by salary would be recorded as a cost in the firm's accounts, whereas a profit share would not. Therefore, one firm could appear less profitable than another simply because it has adopted a salary-based remuneration model, not because it is less profitable in any meaningful sense. Indeed, a firm may report zero accounting profits due to paying one-off bonuses to its partners and/or other staff members.

2.10 In principle, profit could be used as a measure *if* it could be made consistent across firms. This would increase the burden on both: (i) the SRA to provide appropriate guidance on how to record profit; as well as (ii) firms in terms of recording it.

2.11 In practice, it is also harder to measure profit than turnover. This is because one must take a view on revenue, <u>as well as</u> cost. We think that – although it could in principle be done as set out above – it will be particularly challenging given the reasons set out at para. 2.9.

2.12 Similar considerations apply to other metrics such as capital employed and current assets. For example:

- In relation to **capital employed**, we note that:

   - in principle, it does not reflect a firm's ability to pay a fine, as it is not a 'liquid' measure (e.g. the money to pay the fine is not necessarily readily available – that is, the firm may need to raise finance, such as borrowing); and

[4] *We note that some profitability metrics include interest payments.*

  - in practice, for some firms, the balance sheet does not show up-to-date market values of long-term fixed assets, such as offices and vehicles.[5] Instead, the amount that each asset originally cost is recorded and a fixed annual amount for depreciation of buildings, plant, and equipment is deducted. This links back to the issues considered under profitability and how different firms may adopt different depreciation profiles, which in this case could affect the amount of capital employed.

- In relation to **current assets**, similar considerations to those raised just above apply. In relation to cash specifically, different firms may have different reasons to (not) keep cash in the bank. There can be significant variation in the amount of cash held by companies as a proportion of turnover. This arguably reduces the comparability of operating performance to determine a firm's means because it masks the fact that companies holding cash could reinvest it in other opportunities.

- Other considerations, which hold across all the metrics, but which might be even more challenging to measure, include a firm's ability to:

  - raise finance, such as borrowing, which might affect a firm's balance sheet position; or

  - make cost savings, which might affect a firm's profitability.

2.13 Therefore, we consider that there is no *a priori* advantage of using profit (or any other of the considered metrics) over turnover, where profit (and other metrics) may pose significant (and likely contentious) measurement challenges, as well as being more volatile than turnover.

2.14 We also note that all other regulators base their financial penalties on a firm's turnover, as set out in the SRA's annex to the consultation,[6] and as reviewed further by us at para. 4.6.

2.15 Given we consider firm turnover to be the most appropriate and practical metric, we now turn to assessing the scope of the turnover that the SRA should consider, when setting the financial penalty that is within a firm's means.

5 *Depending on their accounting practices.*

6 *See: https://www.sra.org.uk/sra/consultations/consultation-listing/financial-penalties-2021/*

2C. Considering the scope of turnover

2.16 As set out in para. 2.3, the SRA currently considers firms' *annual domestic turnover* to determine whether they are of greater of means. By "annual domestic turnover" the SRA refers to "*the most recent figure which the SRA holds prior to the matter being submitted to the authorised decision maker as to the turnover in England and Wales of the body*".[7]

2.17 This figure will generally be a good indicator as to the financial means of the firm in question. However, this may not always be the case. For example:

a. Where a firm is part of a global enterprise, its global turnover may better reflect the firm's ability to pay than its domestic turnover.

b. Where the turnover in relation to the breach can be identified, this may better reflect the firm's ability to pay in relation to the serious breach. That is, if the firm undertakes various activities, but the breach was committed in one identifiable area, then using the turnover in relation to the area where the breach occurred may better reflect the ability to pay in relation to the specific misconduct.

c. Where a firm has recently undergone an expansion (or a contraction), average turnover over a number of years may better reflect the firm's ability to pay the fine. For example, if the firm merged with another one just before/after committing a serious breach, the average turnover may better reflect the ability to pay, given turnover may have increased/decreased significantly following that change.

d. Where the breach covers a period of more than a year or where the firm's turnover has been volatile between years, average turnover over a number of years may better reflect the firm's ability to pay the fine.

2.18 Notwithstanding the above examples, there are no practical reasons to deviate from the current annual domestic turnover approach from the outset in relation to (a) and (b), as:

[7] *See: https://www.sra.org.uk/solicitors/guidance/financial-penalties/*

- A firm can be part of a global enterprise and the domestic operations can either be a large or a small proportion of the global turnover. Where the England and Wales operations make up a small proportion of the global turnover, it may not be proportionate or fair to levy the fine on the global turnover (especially if the breach only benefitted the domestic operations). Where the domestic operations make up a large proportion of the global turnover, there are less reasons to move away from setting the penalty based on the domestic turnover, as that would better reflect the firm's means to afford the fine for its wrongdoing. Moreover, the SRA currently collects firms' turnover in relation to England and Wales, and thus there are both "in principle" and "in practice" reasons to favour this metric.

- It may be particularly challenging to ring-fence a firm's turnover just in relation to the serious breach. This is because the way firms report their turnover may not provide additional splits, nor may it be evident what practice area the serious breach would fall into. For example, if a multi-disciplinary firm reports turnover by practice area, one might be able to identify the turnover in relation to the practice area. However, if the breach was in relation to failure to carry out client due diligence, which resulted in the client's account being used as banking facility to facilitate money laundering – where the client may have used multiple practice areas – this may complicate the apportionment. Moreover, depending on the firm's business model, some practice areas may cross-subsidise others, and the impact of the breach may not be constrained to just one practice area. Therefore, using a firm's domestic turnover in relation to <u>all</u> of its SRA authorised operations appears both more proportionate, and fair.

2.19 Similarly, absent a more detailed case-by-case analysis in terms of the duration of the breach, in theory there are no practical reasons to deviate from the fine being imposed on the annual domestic turnover of the last year prior to the misconduct occurring in relation to (c) and (d), as:

- In principle, averaging the turnover over the years over which the breach occurred could be more proportionate and could better reflect changes in the firm and/or turnover. However, in practice, the SRA would need to set out clearly in advance over how many years it would average turnover, as well as considering all of the above issues on whether to average the firm's domestic or global turnover; or total (from authorised operations) or breach-specific turnover.

- Moreover, rather than averaging the turnover over a number of years, the SRA could multiply the penalty based on the last year prior to the misconduct occurring by the number of years of the breach. This might provide a larger deterrent effect, whilst remaining clear and specific in relation to the timeframe over which the SRA would consider the turnover.

2.20 In summary, we consider that there is no *a priori* advantage of changing the scope of turnover to something other than the turnover in England and Wales of SRA authorised operations in the last year prior to the matter being brought to the SRA's attention.

2D. Recommendation

2.21 Our conclusions in relation to taking account of a firm's means are as follows:

- Turnover is the most appropriate – and practical – metric for assessing means of firms.
- Relatedly, we consider that the annual domestic turnover from SRA authorised activities in the last year prior to the misconduct occurring best reflects a firm's ability to afford the financial penalty.

3 Taking into account means of individuals

3A. Rationale for considering individuals' means

3.1 The key reasons for the SRA to consider individuals' means to pay the fines are the same as those for firms, set out in paras. 2.1 – 2.2. They include the credibility of the financial penalty in acting as both a sanction and deterrent for individuals, whilst being proportionate and fair.

3.2 Currently, the SRA does not take into account individuals' means in a consistent way when setting fines. For example, a trainee solicitor is fined the same amount as a partner in a large city firm for the same breach.

3.3 However, the SRA currently provides for the ability to reduce the financial penalty, *if* the person is of low means. It does so by assessing an individual's *personal financial statement*, which collects extensive information on the individual and their overall wealth position.

3.4 Although responses to the SRA's consultation on financial penalties[8] generally supported proposals to take into account individual's income from the previous tax year, others suggested considering:

– only the income associated with the breach; and

– whether the financial circumstances of the individual had changed for worse since the previous tax year.

3.5 Below, we first consider the merits of using different metrics to income, followed by considering what the appropriate scope of the relevant metric is (i.e. in terms of what activities are included and what time-frame ought to be considered for setting the financial penalty).

3B. Considering different metrics to income

3.6 Other potential metrics to consider individuals' means (other than their income) include net wealth (e.g. considering <u>all</u> of their sources of income, not just their income from practising as a solicitor, as well as all of their assets and liabilities, e.g. properties, investments, etc).

3.7 In principle, net wealth might better reflect an individual's ability to pay. Yet, there are significant practical considerations. Specifically:

[8] *See: https://www.sra.org.uk/sra/consultations/consultation-listing/financial-penalties-2021/*

- The SRA would need to collect and assess a significant amount of information from individuals (from personal details, to house ownership, to expenses and credit commitments). This might be difficult in practice and create scope for inconsistencies in both measurement and appraisal of net wealth. For example:
  - One individual could choose to buy their car outright, whereas another individual could choose to lease it instead. If – all else being equal – both individuals had purchased the same car, the former might be considered to be of greater means as they own an asset and do not have any credit commitments, whereas the latter might be considered to be of lower means as they do not own an asset and have credit commitments to pay.
  - In practice, the individual of greater means may be less able to pay than the one of lower means, as their asset is not liquid and they would need to sell their car first, whereas the individual of lower means may have more liquid means. For example, were they to stop the lease, they would have quicker/easier access to cash and thus be more able to pay – even though they are of lower means.
- Similar issues to those raised for firms at para. 2.9 apply. In particular, how to value and appraise illiquid assets (e.g. property, loans, etc.), that may contribute to an individual's net wealth, but may not provide for a good assessment of their ability to pay, as they would need to either sell the assets, or borrow against them (which may not always be easily and/or quickly done).
- Finally, some assets may reflect household wealth, not individual wealth. For example, where the individual lives with their family, or where they share properties with their partner. In practice, the SRA could apportion some of the household to the individual's wealth. However, this would require further guidance and a consistent approach to both measurement and appraisal.

3.8 We note that the current application to reduce individual's fines if they are of 'low means' captures all of the information required to assess an individual's **net wealth**. This information could be collected for all individuals who committed a breach. However, in practice, this would create both an additional burden on the SRA, as well as the individual.

3.9 Based on the above, we consider that there is no reason why net wealth might better correlate with ability to pay than income from the outset. For example, if we consider two individuals with the same income, but where one of them also has a high net wealth (in terms of say, properties), it is not immediately apparent that the individual with high net wealth is more able to pay than the other one. This is because their wealth is mostly tied up in illiquid assets.

3.10 To the extent that the above considerations are relevant to the SRA's decision making, we do not think that there is an *a priori* advantage of using net wealth over income, where net wealth may pose significant measurement challenges, as well as being more volatile than income.

3.11 As we consider an individual's income to best reflect their means to pay the financial penalty, we now turn to assessing the scope of the income that the SRA should consider, when setting the fine.

3C. Considering the scope of income

3.12 The SRA wishes to consider the individual's income from the previous tax year to when the misconduct occurred, to assess their means.

3.13 This will generally be a good indicator of the financial means of the individual in question. However, this may not always be the case. For example:

a. If the individual's circumstances have recently changed, the average income over a number of years may better reflect their ability to pay. For example, their income could have increased in the last tax year through a promotion; or it could have decreased if they were on maternity leave, etc.

b. Where an individual has multiple jobs, the SRA could consider their income from all their employment, not just the one in relation to the misconduct.

3.14 Notwithstanding the above examples, in theory there are no practical reasons to consider other measures than the income from the employment in which the breach was committed in the tax year prior to the misconduct occuring. This is because:

- Where an individual's circumstances have changed, the SRA may still apply discretion in determining their means. By averaging individual's income for all individuals who committed a breach, the SRA would need to provide clear guidance over how many years it would average income, as well as take into account the subsequent considerations in relation to all of an individual's employment income, or just the one in relation to the breach.

- Where an individual has multiple jobs, it is still practical for the SRA to identify the income specific to the employment in which the misconduct occurred. By using all of an individual's income from all jobs as the basis for the fine, the SRA may not be proportionate and fair. For example, an individual may be pursuing multiple jobs because they are of lower means, and require multiple sources of income. Therefore, setting the financial penalty on all of their income may be disproportionate – especially if in comparison another individual who only has one job is 'only' fined on their income from that job.

3.15 Finally, the SRA may still wish to consider likely future circumstances and/or changes in circumstances to an individual's ability to pay. To do this, it may not even be necessary to depart from any of the above proposed ways to identify an individual's means. Rather, where the SRA finds that the individual's circumstances might change following the misconduct (e.g. by being dismissed from their current role), it may provide them with a longer timeframe to pay the fine rather than just reducing it. For example, we note that the Bar Tribunals and Adjudication Service (BTAS) finds that in some cases, it would be more appropriate to give individuals more time to pay (or agree payments in instalments) rather than reduce the level of the fine.[9]

3.16 In summary, we consider that the SRA should keep the scope to the individual's income related to the employment in which the misconduct occurred – and that this should relate to the previous tax year in which the misconduct occurred.

3D. Recommendation

3.17 Our conclusions in relation to taking account of an individual's means are as follows:

- Income is the most appropriate – and practical – metric for assessing means of individuals.
- Relatedly, we consider that an individual's income related to the employment in which the misconduct occurred should be used – and that this should relate to the previous tax year in which the misconduct occurred.

3.18 This is in line with our recommendation for firms and creates further consistency in the SRA's approach to setting financial penalties.

[9] *See: https://www.tbtas.org.uk/wp-content/uploads/2021/12/BTAS-Sanctions-Guidance-Jan-2022-Version-6-Final.pdf*

4 Increasing the maximum fine level from 2.5% to 5.0% of the relevant metric

4A. Context and background

4.1 Under the current approach, the SRA issues fines across four penalty bands, where only firms of 'greater means' (i.e. with an annual domestic turnover of £2 million or more) get fined up to 2.5% of their turnover, as illustrated in Table 1.

Table 1: Penalty bands

Penalty band	Penalty bracket
A	£500 or £1,000 in all cases
B	£1,001 to £5,000 or if the regulated person is a firm of greater means, up to 0.5% of annual domestic turnover
C	£5,001 to £25,000 or if the regulated person is a firm of greater means, up to 1.3% of annual domestic turnover
D	£25,000 to £50,000 or if the regulated person is a firm of greater means, up to 2.5% of annual domestic turnover

Source: https://www.sra.org.uk/solicitors/guidance/financial-penalties/

4.2 In the consultation,[10] the SRA proposed to increase the maximum percentage of turnover that it can fine from 2.5% to 5.0%.

4.3 Some stakeholders expressed concerns at this proposal, in particular about the impact this may have on some firms, taking into account their running costs, profit margins, etc.

4.4 In the following we first set out other regulators' approaches to financial penalties, for context; followed by an assessment of how a higher threshold might impact different firms of different sizes.

[10] *See: https://www.sra.org.uk/sra/consultations/consultation-listing/financial-penalties-2021/*

4B. Other regulators' approaches to fines

4.5 The SRA set out the approaches to fines of four regulators in its consultation.[11] Ofwat (the Water Services Regulation Authority), the Financial Conduct Authority (FCA), the Information Commissioner's Officer (ICO), and GEMA (the Gas and Electric Markets Authority) all base their fines on firm turnover, where the maximum penalty ranges from 2% to 20% of firm turnover. We note that the lower bound of this range is based on the worldwide turnover of firms, and that GEMA includes a wider scope, which is broader than just a firm's turnover from regulated activities.

4.6 Further to these, we note that:

- The Chartered Institute of Legal Executives (CILex) can fine authorised bodies between 0.5% to 5.0% of annual domestic turnover or up to a maximum of £250 million, whichever is greater.[12]
- The Chartered Institute of Patent Attorneys (CIPA) and the Chartered Institute of Trademark Attorneys (ITMA) can fine registered bodies up to £25 million. [13]
- The Competition and Markets Authority (CMA) and the European Commission (EC) can fine up to 30% of a firm's relevant turnover for competition law breaches,[14] where:
  - the relevant turnover is the turnover of the firm in the relevant product market and relevant geographic market affected by the infringement in the firm's last business year; and
  - the last business year is the financial year preceding the date when the infringement ended. [15]

4.7 Looking at the fines imposed by other regulators, we consider that increasing the maximum fine level from 2.5% to 5.0% is somewhat below the maximum penalties set by some regulators.

4.8 It follows that by aligning the maximum penalty to those set by other regulators, the deterrence effect of the financial penalties has the potential to increase.

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11 *See: https://www.sra.org.uk/sra/consultations/consultation-listing/financial-penalties-2021/*
12 *See: https://cilexregulation.org.uk/wp-content/uploads/2018/12/Enforcement-Handbook-Annex-6.pdf*
13 *See: https://www.legislation.gov.uk/ukdsi/2014/9780111122020/schedule/2/part/1/crossheading/disciplinary-arrangements-financial-penalties ; https://www.legislation.gov.uk/ukdsi/2014/9780111122020/schedule/4/part/1?view=plain*
14 *Where the financial penalty has a maximum threshold of 10% of a firm's worldwide annual turnover.*
15 *See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1060671/CMA73final_.pdf ; https://ec.europa.eu/competition-policy/antitrust/procedures/fines_en*

4C. Impact of increasing the maximum threshold

4.9 All else equal, increasing the maximum fine level from 2.5% to 5.0% of turnover will increase the deterrent effect of the fine. This could affect firms via two routes:

a. Whether or not they are ultimately fined, it could encourage more firms to take further steps to mitigate the risk of incurring a fine.

b. If a firm is fined, it may have to pay a higher fine than it would otherwise have done, which may affect its ability to pay.

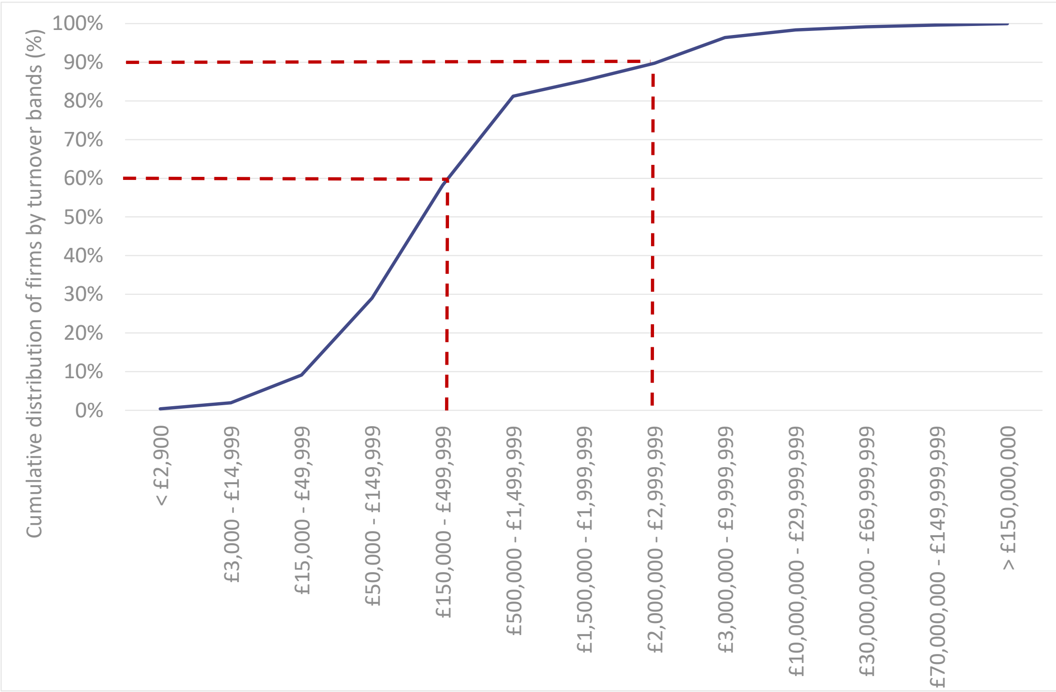
4.10 The extent to which these effects materialise in practice depends on various factors, including the extent to which the maximum level of the fine influences firm behaviour. In the following, we consider the extent to which each of these effects is likely to materialise, as well as their impacts on firms of different sizes.

Encourage further steps to mitigate risks of incurring fine

4.11 One of the key reasons to increase the maximum fine percentage from 2.5% to 5.0% is that – all else equal – it may encourage firms to take additional steps to ensure they do not breach the SRA's rules and standards.

4.12 We note that 90% of SRA regulated firms had a turnover of less than £2 million in 2020-21, and that almost 60% of firms regulated by the SRA had an annual turnover of up to £500,000 in 2020-21, as illustrated in Figure 1.

Figure 1: Cumulative distribution function of SRA regulated firms by turnover bands, 2020-21



Source: Economic Insight analysis of data provided by the SRA

4.13 Thus, all else being equal, all these firms (regardless of size) would potentially face a higher fine, which may encourage increased steps to comply with SRA rules and standards. This would not disproportionately affect smaller or larger firms – as ultimately, both small and large firms should take the required steps to comply with the SRA rules and standards. However, by taking additional steps to avoid a potentially higher fine, we expect that this would lead to both small and large firms facing a lower likelihood of: (a) being fined in the first place; and (b) undertaking such serious misconduct as to warrant the maximum fine.

4.14 To the extent that firms behave in the way set out above, raising the maximum threshold to 5.0% may simply increase compliance with SRA rules and standards. For example:

- On the one hand, firm A, with an annual turnover of £500,000 may not have invested in a regular compliance programme or CPD courses for its employees, where the maximum fine it would expect would be £12,500 (or 2.5% of its turnover). However, were this to double to £25,000 (or 5.0% of its turnover), this may have encouraged it to provide its staff with more resources to avoid misconduct.
- On the other hand, firm B, with an annual turnover of £2 million may similarly not have considered it cost beneficial to undertake additional compliance programmes or other activities to mitigate the risks of breaching SRA rules and standards, where the maximum fine it would face would be £50,000 (or 2.5% of its turnover). Similarly, were this to double to £100,000 (or 5.0% of its turnover), this firm may reconsider its current approach to risk mitigation and increase it to avoid being fined.

4.15 That is, firms of all sizes face a similar degree of cost increase (were they to breach the rules), and all firms can decide – based on their assessment of their means and risk appetite – whether they may wish to mitigate the risk of incurring a high fine (proportionate to their turnover) – and thus reduce their profitability.

4.16 We note that the increase in the fine level from 2.5% to 5.0% *may* increase other firm costs, such as firms' Director's and Officer's liability insurance premiums (and thus reduce their profitability). To understand the impact of this we need to assess the following:

a. whether it is an industry wide cost or not (and thus whether it affects all firms equally);

b. whether it is a significant cost or not (i.e. the magnitude of the cost); and

c. whether it is a fixed or variable cost (and thus whether it affects firms' profitability or not).

4.17 On (a), we understand this insurance is not mandated by the SRA, and to the extent that it is not mandated, we do not expect all firms to take out this insurance (and relatedly incur these costs). However, we would need more evidence to understand the prevalence of this insurance cost, as it may not be mandated, but most firms may take it out regardless. We note that the Law Society ran a yearly survey of solicitors' experiences renewing their professional indemnity insurance (PII),[16] which is mandated by the SRA. The last published results relate to 2017-18, and there, solicitors were asked whether their firm had considered or had taken out: (i) cyber insurance; and (ii) data insurance. Overall, only 21% and 17% of firms had taken out cyber and data insurance, respectively.[17] This varied by firm size, with larger firms more likely to have taken out these additional (non-mandatory) insurances. To the extent that firms view Director's and Officer's liability insurance similarly to cyber and data insurance, one might expect a similar incidence across the population of law firms.

4.18 On (b), one would need to understand the magnitude of this insurance cost compared to all other operating costs, to assess the impact on firms' profitability and whether it affects small firms disproportionately more than large ones. PwC runs an annual law firm survey,[18] which provides key performance indicators across the industry by firm size. The 2021 PwC Law Firms' Survey suggests that insurance costs make up between 1.1% (for the top 10) to 2.5% (for the top 51-100) of fee income.[19] To the extent that these costs include all insurance costs – including the obligatory ones, such as PII – we expect these costs to be of a relatively low magnitude. Especially when compared to staff costs, which the survey suggests make up between 37.1% (for the top 10) to 45.5% (for the top 51-100) of fee income.[20]

4.19 On (c), we note that in a competitive market, a *variable* cost increase is likely to be passed on to the end consumers (and thus would not affect a firm's profit margins immediately), whereas a *fixed* cost increase is generally absorbed by the firms (and thus would reduce a firm's profitability).[21] To the extent that insurance (or higher fine) costs are fixed (i.e. they do not vary with the volume of work the firms undertake), we would not anticipate these being passed on to the consumers in a perfectly competitive market. In turn, were these costs to increase, this would mean firms' profitability would reduce, as they would not be able to pass on this cost and absorb it themselves.

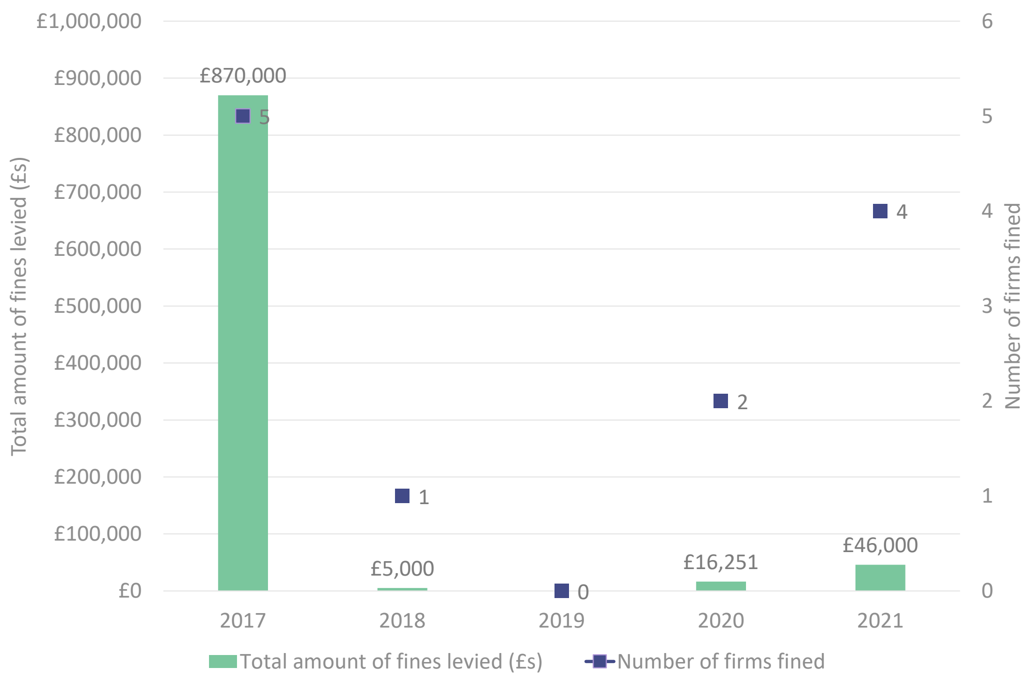
[16] *See: https://www.lawsociety.org.uk/en/topics/research/pii-surveys*
[17] *'Professional Indemnity Insurance Research report 2017-18'. Mustard (September 2018); pages 35-36.*
[18] *See: https://www.pwc.co.uk/industries/legal-professional-business-support-services/law-firms-survey.html*
[19] *'Facing the future with confidence: PwC Law Firms' Survey'. PwC (2021); page 10.*
[20] *'Facing the future with confidence: PwC Law Firms' Survey'. PwC (2021); page 10.*
[21] *Variable costs change as production volumes change, whereas fixed costs remain the same regardless of whether volumes change. Therefore, changes in fixed costs are more likely to affect a firm's profitability than changes in variable costs.*

4.20 The extent to which firm behaviour will be influenced by the maximum level of the fine depends on the perceived risk of being fined at the maximum level, which in turn depends on the SRA's historic enforcement behaviours (i.e. the number of fines it imposed at the maximum level).

4.21 We understand that historically, the SRA rarely imposes fines on firms, most frequently fining individuals. This is illustrated in Figure 2, which shows the number of firms the SRA fined over the last five years, as well as the cumulative £s value of the fines imposed. As can be seen:

- The maximum number of firms being fined in any given year was five in 2017, with no firms being fined in 2019. This stands against 48 individuals being fined in 2017, and 49 in 2019.[22]
- The highest cumulative value of fines was £870,000 in 2017, with individual firm fines ranging between £20,000 to £500,000. In comparison, the four firms fined in 2019 had a cumulative value of fines of £46,000, with individual firm fines ranging between £6,000 and £25,000.

Figure 2: SRA firm fines, number and £s value, 2017 - 2021



Source: Economic Insight analysis of data provided by the SRA

[22] *Based on Annex 3 published alongside the consultation. See here: https://www.sra.org.uk/sra/consultations/consultation-listing/financial-penalties-2021/*

4.22 Based on the above historic enforcement behaviour by the SRA, it may be difficult for firms to create expectations either way. Whether increasing the fine from 2.5% to 5.0% will lead to firms increasing the steps they take to mitigate the risks of incurring a fine, and thus lead to there being less breaches overall, will have to be monitored by the SRA.

4.23 Finally, there is still discretion on the SRA's part on whether it <u>ever</u> applies the maximum fine percentage. Where it does, it will further reinforce the deterrence impacts for the most serious misconduct. These in turn may lead to less firms breaching the rules, and thus lessen the SRA's requirement to impose the maximum penalty.

4.24 Therefore, in theory there is no reason to expect that increasing the fine level from 2.5% to 5.0% might affect the viability of firms in general, or disproportionately affect smaller firms more or less than larger firms. This is because all firms are exposed to the increase in the (potential) maximum fine, which is proportionate to their revenue. It follows that the "playing field" is not tilted in favour of one firm over another in a manner that would cause one firm to have to absorb the costs associated with mitigating the risk of incurring a fine (thus reducing its profitability) to remain competitive with other firms.

Impact of likelihood of paying a higher fine

4.25 Assuming the threshold for the financial penalty increases from 2.5% to 5.0%, the main immediate impact on firms that have breached SRA rules and standards is that they might pay a fine up to double the amount they would have previously paid (as set out in para. 4.14).

4.26 Thus, the key question here is whether a 5.0% fine would compromise the viability of the firm – irrespective of its size – where a 2.5% fine would not.

4.27 We consider that increasing it from 2.5% to 5.0% could compromise a firm's viability if any of the following conditions hold:

- the firm does not earn sufficient profit to pay the fine (i.e. it earns a profit margin of more than 2.5% but less than 5.0%);
- it cannot use reserves or gain access to other sources of finance to pay the fine;
- it cannot make other cost savings to pay the fine; and
- it cannot spread the fine over more than one year (e.g. retaining profit over several years in anticipation of paying the fine and/or spreading the payment of the fine over several years).

4.28 Returning to the example at para. 4.14 above, one would need to believe that:

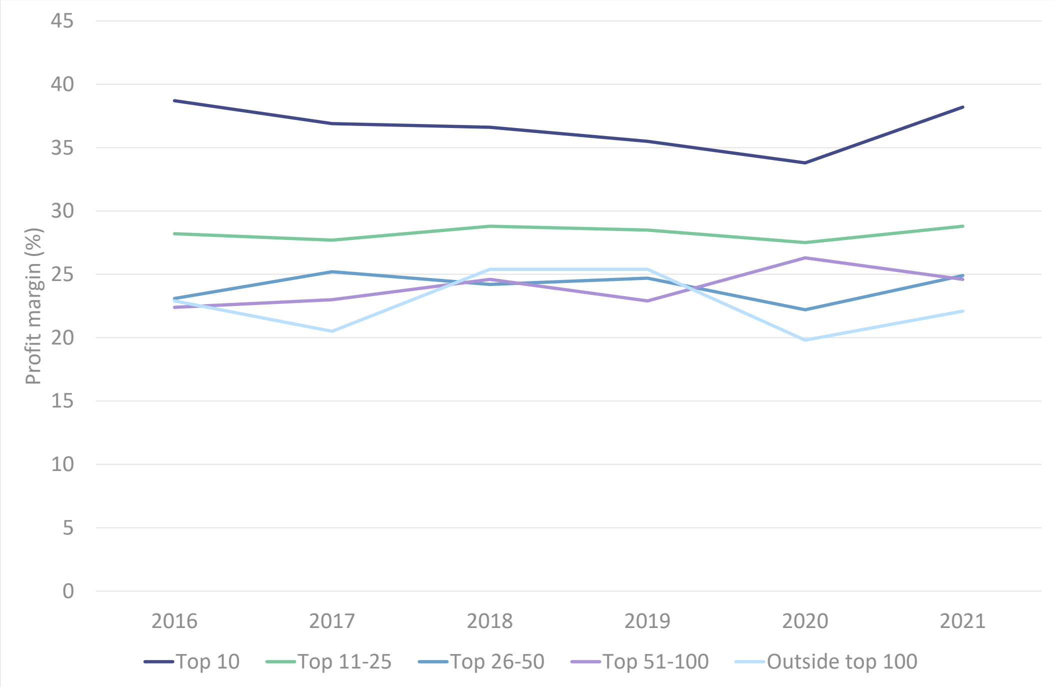
- Firm A would be earning profits of less than £25,000 but more than £12,500 and would have no other means to gain access to alternative sources of finance (such as for example taking out a loan) or implementing additional cost savings to be able to afford to pay the fine.

- Similarly, that Firm B would be earning profits of less than £100,000 but more than £50,000 and would again not have the means to access alternative sources of finance or implement cost savings, to afford the fine.

- Thus, the key consideration regardless of firm size, is whether the firm's profit margins are *sufficient* to cover the fine. There are various reasons as to why a firm's profitability might be different – even where firms are of the same size. It might affect smaller firms more than larger ones if there were high fixed costs in the industry, which the larger firms would be able to spread over a larger revenue figure than smaller firms (and thus have a higher profitability than smaller firms). However, as illustrated in Figure 1, almost 60% of SRA regulated firms had an annual turnover of up to £500,000 in 2020-21, which shows that the legal services industry is not characterised by many large firms – rather the opposite, there are many smaller firms.

4.29 Further, we note the difficulties set out in chapter 2 in relation to alighting at a comparable metric of profitability across firms. Notwithstanding these challenges, we note that PwC's Law Firms' Survey provides firm's profit margins (%) between 2016 and 2021, as illustrated in Figure 3. As can be seen, in 2021, profit margins ranged from 22.1% for smaller firms (outside top 100) to 38.2% for larger firms (top 10). This indicates that – on average – law firms earn profits in excess of 5.0%, i.e. their profits are greater than the proposed fine.

Figure 3: Profit margin (%), UK law firms, 2016 - 2021



Source: Economic Insight analysis of PwC Law Firms' Survey 2021[23]

4.30 Looking at the movements in profit margins between years, we note that in some instances, profit margins fluctuate by more than 2.5 percentage points between years, as illustrated in Table 2 (bolded). This suggests that, in principle, firms may be able to withstand a 2.5 percentage point increase in the fine level, as they withstood general changes in profitability in excess of that.

Table 2: Profit margin percentage point difference between years, UK law firms, 2016 - 2021

	2017	2018	2019	2020	2021
Top 10	-1.8	-0.3	-1.1	-1.7	**4.4**
Top 11-25	-0.5	1.1	-0.3	-1	1.3
Top 26-50	2.1	-1	0.5	**-2.5**	**2.7**
Top 51-100	0.6	1.6	-1.7	**3.4**	-1.7
Outside top 100	-2.4	**4.9**	0	**-5.6**	2.3

Source: Economic Insight analysis of PwC Law Firms' Survey 2021[24]

[23] *'Facing the future with confidence: PwC Law Firms' Survey'. PwC (2021); pages 32-33.*
[24] *'Facing the future with confidence: PwC Law Firms' Survey'. PwC (2021); pages 32-33.*

4.31 In summary, there is no 'in principle' reason to expect that this route would disproportionately affect smaller firms more or less than larger law firms. Again, this is because the fine is proportionate to revenue and there is no *a priori* reason to expect that smaller firms will be earning lower profit margins than large ones in the legal services sector – and that they are currently earning profit margins that would enable them to pay a fine of 2.5% of their turnover, but not a 5.0% one. 'In practice', the evidence set out at paras. 4.28 and 4.29 shows that smaller law firms earn slightly lower profit margins than larger ones, but that regardless of size, these margins are above 5.0% - with even smaller firms earning profit margins in excess of 20.0%.

4.32 Finally, if a firm's viability is compromised by the change in the maximum fine, regardless of the firm's size, the SRA's approach to fining (beyond the maximum level of the fine) can influence a firm's ability to pay. For example, by allowing the firm to pay over multiple years, it could maintain both the firm's viability and the fine's deterrence effect. This would be in line with the approach the BTAS takes to ensure affordability of individual fines, set out in para. 3.15.