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THINKERS

How legal firms are impacted
by financial services disruption

Executive Summary

Last year Travelers and The Lawyer collaborated on a research report entitled ‘Legal innovation and risk management’. The report tackled two main questions – how are law firms innovating to respond to client demands and what impact is this having on risk management?

In summary the report revealed that, from the use of disruptive technology and flexible working practices to alternative fee arrangements and the provision of non-legal services, law firms are innovating in many different ways. But these innovative practices are creating a new set of risks that need to be carefully managed.

This follow-up paper takes some of the questions we asked and turns them on their head. Instead of querying how law firms are innovating we interviewed private practice lawyers and in-house counsel to understand how clients are innovating and how their demand for legal services is changing. We also asked how law firms are responding to these changing demands, both in terms of seizing new opportunities and managing new risks.

This is a wide ranging question, so in this paper we focus specifically on innovation in the financial services sector. This report summarises the views of a series of partners at financial services practices and in-house counsel at innovative companies.

Pockets of innovation

Few could argue that banking and insurance hasn't long been dominated by a relatively small set of well known high-street brands. But this doesn't mean that innovation isn't taking place in this sector. From crowdfunding platforms and the block chain to digital signatures and inventory finance, our research outlined a huge number of areas where start-ups and multinational corporations are creating innovative technologies, products and business models.

And where there's innovation there's work for law firms. Rapidly growing innovative businesses need to raise capital, which requires advice from corporate lawyers. Companies developing new products also need legal advice relating to licensing and ensuring that their products are compliant with industry regulations.

Digital signatures

So what are the most disruptive innovations within financial services? One area frequently mentioned by experts is the increasing use of digital signatures, which demonstrate the authenticity of digital messages or documents. Digital signatures enable financial products to be sold rapidly at distance because they remove the need for documents to be physically signed in person.

According to research conducted by P&S Market Research, the global digital signature market will grow from just over \$500 million in 2015 to over \$3.3 billion in 2022.

Stephen Dawson, Partner and head of the consumer finance team at Shoosmiths, explains how the rapid adoption of digital signature technology across the financial services industry has affected the sale of some financial products. “The big differentiator nowadays is digital signatures. It means speed and is perhaps one of the benefits of payday lenders placing technology at the heart of sales.”

“The speed at which financial products can be concluded is one of the biggest stories for me in the last 18-24 months. In 15 minutes a customer can now conclude all sorts of financial services products, together with providing ID verification and AML (anti money laundering) searches. There is now no need to photocopy paper and fax off copies.”

However, like many other innovations in the financial services sector, the emergence of new products has created headaches for regulatory lawyers. “This is a massively challenging environment for regulatory lawyers because the legislation, and many lawyers, have not been able to keep up,” continued Dawson. “We moved into digital signatures in the financial services space with little or no case law to support us. We had some high level legislation and government papers discussing electronic communications, but little certainty.”

Inventory finance

New innovative financial products that target previously underserved markets are emerging and one example is inventory finance. Primarily utilised by online retailers, this is typically a short-term loan secured to fund purchases of inventory for sale. These products are then used as collateral if the loan cannot be repaid.

This is an innovative form of finance as it is not typically provided by traditional banks and serves SMEs that usually struggle to secure finance.

Christoph Rieche, co-founder and CEO of IWOCA, a specialist provider of inventory finance, explains how the product works and how the company's legal requirements have evolved.

Travelers insight: How to advise clients when the future regulatory framework is uncertain

Innovation in the financial services sector, whether it be digital signatures, inventory finance, blockchain technology or something completely different, typically happens in a static regulatory environment. This can lead to the introduction of products or processes where there is no regulatory infrastructure for clients to follow.

This creates risks for law firms as clients may blame them for failing to warn of new regulation and legislation. Law firms should do the following to mitigate this risk:

- Clarify why the product or service does not fit into the existing regulatory regime.
- Check if there is any analogous situation or reference to underlying principles of regulation that can provide guidance as to how the product or service might be viewed by the regulator in future.
- Try to discuss with the regulator whether it is possible to gain an informal indication as to how a particular development is viewed.
- Try to point to experience in other jurisdictions or of other regulators to guide the client.
- Assist the client in assessing the risks posed by a particular development and suggest controls to forestall these.
- Ensure the client is aware of the extent of the lack of regulation and legislation and the potential risks that this poses if they proceed with the proposed product or process.

“We have a technology platform that enables us to understand small businesses faster and in a more innovative way than banks,” he said. “This enables us to understand the risks of these companies in a way that others can’t because they don’t have the systems in place to do it in a cost effective way. This enables us to finance small businesses generating between a few thousand and two million in revenues.”

“We require legal services across the board, especially for corporate transactions, of which we have had plenty through raising both equity and debt. On the operational side, we need to ensure we are conducting business in accordance with the regulations so need legal advice for this. Regulation has not 100% caught up but we are not held up by regulation either.”

Crowdfunding

When new business models and financial products are created it’s not just the companies developing the solutions that require legal expertise. Take the example of crowdfunding. According to the Massolution crowdfunding report 2015, over \$34.4 billion of equity was raised on crowdfunding platforms in 2015, more than double the \$16.2 billion raised in 2014. But it’s not just the crowdfunding platform providers that require legal advice.

For example, Bond Dickinson’s financial services team worked with an insurance company to develop a policy for investors on crowdfunding platforms. “In the last six months it’s become very apparent that crowd-funding is not a risk free enterprise,” said Jonathan Drake, Partner at Bond Dickinson.

“People do lose money. We worked with an insurer to develop a product that covered people if they were defrauded. This is a good example of a new innovative insurance product to deal with new technologies and business models.”

Blockchain

Digital currencies such as Bitcoin have grabbed the headlines in the last twelve months as prices have swung massively and uptake has surged. But it’s the technology that underpins many of these new currencies that really excited our series of contributors.

This technology, called the blockchain, is a distributed ledger of transactions that is not maintained by a trusted third party. Instead it is maintained by users across a network who agree by consensus what the latest true version of the ledger is. This technology is advantageous as it ensures there is always a true copy of the ledger that can’t be manipulated by a single entity. The technology has numerous applications beyond virtual currencies, from making procurement processes and land registry more efficient to ensuring diamond transfer is transparent.

Why are law firms interested in blockchain developments? Adrian Shedden, Head of Fintech at Burges Salmon, explains. “At the moment we advise organisations on the regulatory perimeter (which hasn’t been developed with blockchain in mind), for example; how a particular regulation might be considered to apply to them,” he said. “The regulators were too far behind, but are increasingly taking the lead through, for example, the Bank of England Fintech Accelerator’s work on distributed ledger tech or the FCA’s Regulatory Sandbox, which actively fosters innovation, including some blockchain solutions.”

“So lots of our work involves working with regulators on what they might apply in future. One complication is that blockchain runs across borders, so what law and dispute resolution mechanism applies to a contract if, for example, it is not stated in the contract. Is it the server where most of the code is operated or something else?”

There are plenty of legal questions to consider as concrete applications of blockchain tech are emerging – 2017 is the year we properly go to work on this.”

A booming venture capital market

All of this innovation requires funding, so it is unsurprising that investment into financial services companies is booming. According to data compiled by KPMG and CB Insights, some \$14.4 billion was invested in fintech companies globally in 2015, almost double the \$7.3 billion invested in 2014. Investment is on course to increase again this year.

Capital raising transactions, whether they be in the form of venture capital investments or a public offerings, require expert advice from external counsel.

“Whilst we have capital markets specialist lawyers in-house, given that our capital markets work is transactional and requires a large team for specific periods of time which we could not sustain in-house, we work with law firms,” explained Martin Cook, General Counsel, UK, at small business lending platform Funding Circle, which has raised \$300 million of equity capital since 2010.

“When we set up Funding Circle SME Income Fund Limited (a Guernsey-based fund listed on the London Stock Exchange) we worked with outside counsel. Given that there was a lot of work in a short time frame, it required a multi-disciplinary approach (foreign law, tax, funds and corporate finance) and it was a public markets deal.”

Travelers insight: The evolving role of the lawyer

The above examples demonstrate how lawyers are changing the way they deliver legal services. Firms will also need to continue to demonstrate that their services are of value to clients, both in the financial services sector and beyond.

This means understanding their clients’ world – the environment in which an organisation seeks to achieve its objectives – so as to better understand the clients’ requirements. As well as talking to clients, lawyers could use some approaches taken from their firm’s own risk management efforts.

- Horizon-scanning: Law firms should maintain a watching brief to identify developing risks and opportunities which may affect their clients.
- PEST analysis: Law firms should review the political, economic, social and technological forces that could affect their clients.
- Scenario planning: Law firms should plan for the future by imagining a number of possible futures – optimistic, pessimistic and realistic – and develop a plausible timeline from the present to each scenario.

“Lawyers have to spend more time understanding the external environment in which their clients seek to achieve their objectives,” explained Paul Smith, Senior Risk Management Consultant at Travelers. “They need to better understand the big picture issues. Where is society going? Where is the country going in terms of economics and business development?”

What are we seeing in terms of IT and life sciences that will impact what clients are expecting in terms of legal advice?”

“To do this law firms are going to have to spend more time engaging with a rapidly changing external environment. They will need to establish this by doing things like horizon scanning – what is coming up and how will this impact the firm and its clients. Lots of large law firms are now sending their senior management teams to courses on advances in AI, life sciences and technology to get a better picture of where things are going.”

“Firms need to take this knowledge they have gleaned and repackage it up into consultancy services. This may be very useful when competing against accountancy firms, which have decades of experience in developing their consultancy arms.”

Travelers insight: Managing the risks of working as a multidisciplinary team

Funding Circle is certainly not the only financial services company that requires its external law firms to work as part of a multidisciplinary team across a range of practice areas. Working in this way creates risks for firms as there may be a lack of clarity around client expectations of the various lawyers involved. There may also be communication issues between the client and advisors. Law firms should do the following to mitigate these risks:

- Be very clear in the retainer what is within the scope of work for any set of instructions and what is not.
- Have retainer management systems and processes in place to track changes in scope, issues, risks and the cost/benefit of pursuing the matter.
- Establish a communications protocol to set out who communicates with whom, how frequently and in what format.

Changing demands

Atomised requests

We also quizzed in-house teams and private practice lawyers on whether there are any industry wide changes in how firms are demanding legal services. One common theme that emerged is that clients are increasingly asking their law firms a large number of small and relatively easy to answer questions. This is partly driven by companies getting used to being regulated by the FCA instead of the OFT.

How are law firms responding to this? One method deployed by Shoosmiths is to work with clients on a retainer basis. “Consumer credit has moved into the FCA space and the handbook when printed is nearly six feet tall,” explained Dawson. “People want quick answers without reading it. And they want us to know their products, their market and their commercial imperatives.

We’ve tried to come up with innovative ways of providing the answers to these questions without having to focus on fees. Historically lawyers charge for time but we have suggested that smaller lenders pay retainers. It works for them as we never have to talk about money and it works for us because they have shown us commitment. We will always go above and beyond for these customers.”

“Simply charging on a time basis, or even fixed fees, just doesn’t work anymore. One of my colleagues has developed ‘Resource Solutions’ a new product in the legal market which breaks legal services acquisitions down into commoditised pre-priced methods for day to day commercial work. It’s trying to offer business as usual legal work at a much lower, preagreed, cost. It has been very popular, as the focus is on doing business, not discussing cost.”

Automating legal work

Nearly every report on in-house legal functions concludes that cost pressures are increasing and that teams are striving to find more efficient ways of working. Our research found that in-house teams at financial services companies are trying to achieve this by using technology to automate repetitive work.

Drake explained that there are significant opportunities for law firms to assist in-house teams to create automated processes. “The biggest area of innovation I’ve seen is in document automation and production,” he said. “For example we work with several insurers and large financial institutions on automating the creation of NDA agreements, of which they may have to turn over 50 a week. It’s a huge resource commitment for our clients and it’s not an efficient use of their time.”

“We’ve worked with a couple of insurers and major banks to take proprietary software and adapt the rules by which that software operates so that it asks a series of questions which the client fills in. The results of this then populate the document. The innovative bit is using our legal thinking to drive what the system asks. Lots of legal thinking has to go into the questions and algorithms that the process uses as well. It meant we had to think less like a law firm and more like a developer.”

Brexit clouding the regulatory landscape

The financial services sector is highly regulated and many of the specific regulations come from Europe. A common theme in our series of interviews with in-house counsel is that there is uncertainty regarding whether UK companies must continue to comply with European regulations following Brexit.

“One of the most challenging areas for us legally is data protection and in particular the General Data Protection Regulations that are coming out of Europe,” explained Gillian Tiplady, Head of Legal, Retail Banking at Atom Bank. “We need to ensure we are compliant and have properly informed consent because increasingly there will be a requirement to have specific consents from customers rather than the generic catch all that people have used in the past. We don’t know what will happen regarding European regulation. We would hope that legislation stays as common as possible. We are very much on an equivalent platform with Europe at the moment.”

FCA authorisation

Some private practice lawyers who contributed to our research mentioned that clients are increasingly enquiring whether their law firms are authorised by the FCA. One that has obtained this is Shoosmiths.

As a firm, we’ve obtained FCA authorisation, which was a huge exercise,” said Dawson. “Very few firms have done this, but it assures clients of our firm wide commitment to quality and risk (where we have appointed a Director role) and helps command confidence. If you have this clients know the whole firm is operating to an FCA standard. We’ve had it for six months now. Some banks are now saying this is a necessity and others are saying it’s deeply reassuring.” An additional advantage of this for law firms is that it enables them to better understand the compliance challenges clients face with FCA regulation. Against this, however, is the cost of obtaining accreditation and complying with additional regulation beyond that of the SRA.

Conclusion

This article highlights just a few examples of the huge amount of innovation in the financial services sector. This is creating some challenges for law firms. For example, the growing use of automated technology by in-house teams may reduce demand for external lawyers. However, the general consensus amongst our experts is that innovation actually presents more opportunities than challenges for firms.

“A lot of people say innovation is bad news for law firms but in some ways in the higher end of the market it is a good thing.”

concluded Jane Challoner,
Head of Tech Innovation at CMS.

“These changes are so widespread and complex and there are so many points of interaction, from tech work and M&A to commercial contracts and regulation, that I think it will not only result in better and more efficient delivery of traditional work but also open up lots of opportunities for more collaboration and new work streams for the large full service firms. To take advantage of this we really need to understand how all these different strands tie together for our clients, where their sectors are going and how we can best shape our offerings to respond to their new requirements.”

Paul Smith echoes this view.

“Innovation means change and experimentation and it generates new challenges,” he said. “With that comes uncertainty and, with that uncertainty, risk for both innovators and their legal advisors. However, as we have seen in the cases above, lawyers can help limit that uncertainty – by understanding the client’s world and the drivers of innovation, thinking how the law might develop when innovation outstrips regulation, embracing new ways of working in response to client demands – and help manage the risks in innovation.”

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