Alternative business structures: approaches to licensing

Consultation paper on draft guidance to Licensing Authorities on the content of licensing rules

This consultation will close on **Friday 19 February 2010.**

Contents

Foreword

This document is the next step in realising the potential of the Legal Services Act 2007. Significant changes in the way that legal services are delivered in England and Wales will be enabled through the relaxation of ownership and management rules allowed by the introduction of Alternative Business Structures (ABS). ABS will provide new opportunities for innovation and entrepreneurship in the provision of legal services. Restrictions on what types of services can be packaged and delivered together will be removed. And ownership by non-lawyers of firms will be allowed.

With the right framework of responsive regulations in place, ABS can open the market and provide the protections consumers need. The Legal Services Board does not want to regulate ABS directly. We prefer to have competent Licensing Authorities that directly license ABS. So we have developed a set of core principles that we expect all Licensing Authorities to use. This can create a consistent market for all legal service businesses with the ability for regulators to tailor requirements. ABS firms can be regulated best by focussing on the outcomes we are trying to achieve rather than a set of strict rules.

This is a significant step forward. I see it as the way that we can achieve good outcomes for consumers, lawyers and investors. The approach encourages good ideas and will ensure that consumers are protected. The Legal Services Act itself sets out a number of protections for lawyers and consumers; this document gives these protections flesh and, more importantly, teeth.

Many of the practices allowable under ABS already take place, often by “working around the rules”. We propose an ABS framework to manage these arrangements in a way that provides the protections consumers need and the flexibility that will benefit consumers. The Legal Services Board has a clear mandate to change the provision of legal services, in the interests of consumers and citizens. This document sets out what we mean by Access to Justice, the issue of where to draw the line on the activities to be regulated, and indemnity provisions.

This is a consultation document. It sets out our thinking but asks for your thoughts. The best design for regulation of ABS will be the one in which all have had their say. So please respond to this document and tell us what you think. Many lawyers have told me personally that they want the freedom to empower their businesses, to enhance access to justice for consumers. We encourage them to tell us their views on the framework they would like.

Many stakeholders engaged constructively with our discussion document issued in May 2009. We have set an ambitious timeframe for ABS. But mid-2011 gives us time to deliver effective change - and for you to be part of it.

DAVID EDMONDS, CBE

Chairman

Executive Summary

1. The Legal Services Board (the "**LSB**") is the organisation created by the Legal Services Act 2007 (the "**LSA 2007**" or "**the Act**") and is responsible for overseeing legal regulators, (referred to as the "approved regulators" in the Act) in England and Wales. The LSB's mandate is to ensure that regulation in the legal services sector is carried out in the public interest; and that the interests of consumers are placed at the heart of the system. The Act gives the LSB and the approved regulators the same regulatory objectives – including an objective to 'promote competition within the provision of legal services - and a requirement to have regard to the Better Regulation Principles.

2. The Act sets out a new regulatory framework for the operation of regulators and the ownership of legal service providers. It gives the LSB a new power to approve "licensing authorities" ("**LAs**"). These are approved regulators who have also been approved by the LSB to license a particular type of legal service provider, conventionally known as "Alternative Business Structures" ("**ABS**").

3. ABS, regulated by newly designated LAs, remove many of the barriers in relation to non-lawyers owning organisations providing legal services and provide new opportunities for innovation, wider access to justice and the re-shaping of legal services in the consumer interest. We consider that the barriers to these outcomes in the current regulatory framework can be safely removed, because the overall framework will ensure that consumers' interests are considered, best professional principles safeguarded and the public protected. This document sets-out how we propose to achieve this and consults on the proposed strategy. This consultation follows on from our previous discussion paper on ABS ("Wider Access, Better Value, Strong Protection" – published on 14 May 2009). All non-confidential responses can be found on our website and summaries of respondents' views are included at the beginning of each chapter of this paper.

4. In some areas, our policy development and our views are at the stage of option appraisal, in others, our policies and views are more developed. Each chapter in this consultation paper asks one main question supplemented by auxiliary questions; these are designed to be "thought starters" rather than definitive – we welcome comments on any aspect of the consultation.

Major themes of this consultation

New approaches to regulation

5. We expect LAs to take an "outcomes-based approach" to regulating ABS which focuses on the outcomes that we expect will support the regulatory

objectives. The Legal Services Board ("**LSB**") will therefore set-out a framework of core outcomes that LAs will be required to adopt. We believe that, over time, this will guide the approach taken by LAs also when they are acting in their capacity as Approved Regulators ("**AR**") regulating non-ABS. We do not consider that adopting this approach in any way equates to "light touch" regulation. In fact, this approach will give LAs increased flexibility in their enforcement enabling the focus to be on "the spirit of the law". The core outcomes we believe should be in the ABS licensing framework are listed on pages 11 to 13.

6. Furthermore, we are proposing that LAs will take a risk-based approach to regulation, both at the time of assessing an application for ABS status and in overseeing legal service providers that subsequently appear to pose the highest risk. We expect LAs to focus their resources correspondingly. Both regulatory policy and supervision should provide a more cost effective and proportionate approach to regulation.

7. This document is a break from the past as it proposes a much stronger regulatory focus on the entity – the systems and activities of the legal service provider as an economic unit – rather than the individual behaviour of lawyers within it. The regulation of the conduct of individual lawyers will remain an important element of consumer protection and the safeguarding of professional practice, but, alongside this, there will be a new focus on regulating the environment in which individuals operate and the compliance systems that govern behaviour within organisations providing legal services.

Consumer protection and professional principles

8. The LSB and the LAs (as ARs) are bound by identical regulatory objectives of:

- protecting and promoting the public interest;
- supporting the constitutional principle of the rule of law;
- improving access to justice;
- protecting and promoting the interests of consumers;
- promoting competition in the provision of services that are provided by authorised persons (including services which do not involve the carrying on of activities which are reserved legal activities);
- encouraging an independent, strong, diverse and effective legal profession;
- increasing public understanding of the citizen's legal rights and duties; and
- promoting and maintaining adherence to the professional principles.

9. Furthermore, the LA must have regard to the principles of Better Regulation under which regulatory activities should be transparent, accountable,

proportionate, consistent and targeted only at cases in which action is needed, and any other principle appearing to the LA to represent the best regulatory practice.

10. As well as the regulatory objectives, the LSA 2007 outlines several protections to ensure that non-lawyer ownership does not undermine the professional principles of lawyers. Three key protections are:

- a test to ensure that non-lawyer owners and managers of an ABS are fit and proper;
- the introduction of two new roles in ABS: the Head of Legal Practice ("**HoLP**") and Head of Finance and Administration ("**HoFA**") who will ensure compliance with licence requirements; and
- a widening of the complaints handling system to deal with complaints from multi-disciplinary practices (i.e. ABS that do not deliver legal services in isolation but instead offer these alongside other services – for example, financial services) and access to the Office for Legal Complaints ("**OLC**").

Regulatory consistency

11. The LSB an oversight regulator. This means that we will only in the most exceptional circumstances be involved in the day-to-day regulation of legal services providers. This day-to-day regulation will instead be undertaken by the ARs (the frontline regulators) who will be the only entities allowed to apply to become LAs (other than the LSB itself). The LAs will regulate ABS on a day-to-day basis. The LSA 2007 allows for the entry of new regulators (and thereby new LAs) and therefore potentially for a degree of competition between regulators overseen by the LSB. Placing any such competition, within a regulated public interest framework will prevent "dumbing down" of regulatory requirements, will enable a regulated entity to pick the most appropriate regulator for it and will promote better, more targeted and more proportionate regulation. This should raise the standards of regulation within all LAs.

12. The LSB, as an oversight regulator, will harmonise the regulatory framework for ABS in relation to the core outcomes. The competition between regulators will then manifest itself in the way that they regulate beneath these core outcomes. We believe this approach will help all ARs – including both the existing frontline regulators, and new entrants – to meet our standards for LAs and provide incentives to make further improvements beyond the minimum criteria. Above all, the adoption of common core outcomes will mitigate the risk of some LAs being perceived as having weaker regimes.

Ownership tests

13. The LSA 2007 sets out a test for non-lawyer managers and owners of ABS. Heavily modelled on a similar test within the Financial Services and Market

Act 2000, the LSA 2007 test is designed to ensure that all those who hold influence over ABS are fit and proper to do so. These requirements provide strong protection to the public in relation to the ownership of ABS.

14. We have had discussions with both the Financial Services Authority ("**FSA**") and the Gambling Commission to understand how they implement equivalent tests. But the test for ABS should be distinct and tailored for the needs of the legal services sector. There should be one fit and proper test for all owners and managers that is consistent across all LAs to include a check for a criminal record, disciplinary action or any disqualification to ensure an appropriate level of consumer protection. This will be a one-time test, although there will be an obligation to notify the LA of changes in circumstances that are relevant to this test and we expect LAs to check this in supervision. In terms of the actual ownership of an ABS, we believe that strong ownership tests mean that there should be no restriction on how much of the business non-lawyers will be allowed to own: any limit would be arbitrary and therefore represent an unjustifiable barrier to the emergence of different business models.

15. Furthermore, if a corporate ABS is publically listed on a recognised investment exchange, we believe that it should make a clear statement in its constitutional documents of the regulatory duties that apply to its commercial activity by virtue of being a regulated legal services provider. The principle should be that a duty to a shareholder does not compromise the duties owed to the court and to their client. We consider that this approach may also be appropriate for other forms of ABS.

Indemnity and compensation

16. Professional indemnity insurance ("**PII**") and discretionary compensation funds are the main mechanisms to provide redress for consumers when lawyers make mistakes or are dishonest. Our clear starting position is that customers of an ABS should be no less protected than those in other parts of the market. But we have identified a number of issues with current arrangements for PII that go wider than ABS (including the functioning of the compensation funds, the scope of activities covered by insurance and providing "run-off" cover) and will be considering them as soon as possible with ARs and other interested parties.

What are "reserved legal activities"?

17. LSA 2007 identifies only a limited number of activities which are deemed to be "reserved legal activities", which only "authorised persons" are allowed to undertake (i.e. lawyers regulated by an AR). However, reserved legal activities are not the only type of regulated legal activity. Currently, authorised persons are generally regulated by their AR in respect of any legal activity they undertake – not simply "reserved legal activities". Because there is only a

small number of activities which are labelled as “reserved legal activities”, this creates a situation that some legal activities can be delivered exclusively by non-authorised persons and hence not be regulated by an AR. This presents a regulatory policy dilemma: are the risks and costs of such an extension to the scope of regulation greater than those arising from actual or potential consumer confusion and mis-purchase?

18. To address this, we believe that there is a need to collect better evidence on how well consumers understand the current situation and whether any actual or potential detriment arises from any confusion. We will make proposals for work on this issue in our 2010-11 Business Plan, in relation to both ABS and the wider marketplace. But we consider that ABS must provide the same level of consumer protection for reserved and unreserved legal activities as in the current market. In addition, we consider that a minimum requirement is transparency for consumers. They should be free to purchase any legal service, including an unregulated legal service, but they must be made aware: (i) that the legal service being purchased is unregulated; and (ii) what protections a LA provides in these circumstances. We therefore expect LAs to focus on educating the consumer on what is or is not subject to the protection of regulation. This can be done both directly and, where practicable, through requirements they place on ABS.

LA enforcement and penalties

19. The Act gives LAs the power to take enforcement action against an ABS for non-compliance. The enforcement strategy that the LSB proposes has been shaped in parallel to its own enforcement strategy in relation to ARs and LAs. The emphasis, therefore, is on informal resolution insofar as possible, but ensuring that this is backed with a clear escalation of action against the ABS in circumstances where that fails. Key powers, the precise sequencing of which will depend on the nature of the offence and scale of risk to the public, include disqualification of employees or managers of the ABS, the ability to fine them (as well as the licensed body itself) and an ability to intervene and take over the practice of the legal services provider.

20. As part of regulatory policy-making around enforcement powers, the LSB is also required to recommend the maximum amount of the financial penalty. We propose that this should be an unlimited amount, both for individuals and entities, but with a requirement that a LA must act proportionately according to the particular circumstances of the case.

Access to justice

21. Ensuring that consumers have the ability to access the right legal services, in the right way, at the right price, is crucial for optimising access to justice. We see this as a key outcome for supporting people both as consumers and citizens, as well as for complementing legal aid for those who are not entitled

to it, but who nevertheless struggle to afford the necessary advice. It is our view that ABS can play a key role in widening access to justice by creating new diversity in the range and value of legal service offerings and providers as a result of increased competition and innovation. It may be that a wider variety of legal service offerings allow for a more diverse consumer base.

22. To ensure that ABS play this key role, we propose that LAs gather evidence to track the impact of the ABS regime over time against the regulatory objective of improving access to justice. This approach to assessing impact will allow the LAs to make informed decisions when addressing any risks to that regulatory objective. We would not expect LAs to focus exclusively or even mainly on measures such as the number of high street firms in a given locality. Rather we expect them to take a more sophisticated view of the provision of services in all media, the public's ability to access them in an informed way and the impact on overall measures of legal need. We also would not normally expect LAs to turn down licensing applications on the basis of risks to legal services provided by other suppliers, but we would expect them to require applicants to show how their business will help improve access to justice and to monitor this over time.

Appellate bodies

23. When LAs make decisions based on their rules, it is essential that those who are subject to those decisions need to have an avenue to appeal. It is our proposal that all these appeals should be heard by a single body (as opposed to expanding the mandates of the current appeal bodies, such as the Solicitors' Disciplinary Tribunal and the CLC's Discipline and Appeals Committee). This will allow for a single coherent body of jurisprudence to form around appeals to licensing decisions and also provides a suitable appeals path should the LSB itself become a direct licensor. We have had an initial discussion with the Tribunals Service about this body being housed within the General Regulatory Chamber and, subject to any technical issues and the outcome of this consultation, no difficulties of principle have been identified.

24. In the longer term, we see potential value in exploring the suggestion that all appeals from any AR's decisions should be heard by this body. This document does not address this wider issue.

Special bodies

25. Particular groups of entities are identified in the LSA 2007 as requiring special consideration. These include law centres, citizens' advice bureaux, some other advice agencies and independent trade unions. It is our view that such bodies should be subject to regulation where they provide legal services to the general public. The LSA 2007, however, provides that the regulation that such bodies are subject to can be less burdensome because of the public benefit provided by such organisations and the perceived lower risk that many

of them pose to the regulatory objectives. However, we believe that it is not in the interest of the public nor of the special bodies themselves for there to be significant and prolonged departures from the essentials of the regulatory regime.

26. Our view therefore is that special bodies should be given a "grace" period of 12 months following the introduction of the first ABS (anticipated to be) in mid-2011 to make the transition to regulated entities. LAs should consider how to adapt their regulatory regimes for special bodies subject to meeting a core set of minimum requirements, so that they are ready to receive applications from special bodies at the end of the "grace" period.

HoLP/HoFA

27. An ABS must at all times have a Head of Legal Practice ("**HoLP**") and a Head of Finance and Administration ("**HoFA**"). The HoLP will be a lawyer within the ABS who will have a key role in ensuring compliance with the terms of the ABS's licence, as well as a duty to report any non-compliance to the LA. A HoLP must also ensure that all employees and managers comply with the duties to ensure that lawyers adhere to their professional values and that there are systems in place to enable this. Similarly, the HoFA must ensure that the ABS complies with licensing rules made about accounts and must report any breach of those licensing rules to the LA. The HoLP and the HoFA may be the same individual within an ABS, but both must be subject to a "fit and proper person" test (essentially the same test as for someone who wishes to own an ABS), as well as possible ongoing training requirements.

28. The HoLP and HoFA will have a key role in the ABS and, in view of this, it is important that they report directly to senior management. We provide guidance on how a HoLP or HoFA should conduct themselves in a fit and proper manner, as well as the working practices that they should encourage within the business.

29. We believe that these roles provide important reassurance to the public about standards of regulation, practice and access to redress within an ABS. We therefore consider that they may provide a step change in the standards of governance in the market generally and that LAs should consider monitoring whether this happens in practice.

Complaints

30. It is our view that effective complaints handling is essential in ensuring that consumers get appropriate redress quickly when things go wrong and also to help businesses learn from their mistakes. Consumers of legal services provided by ABS should be afforded the same protections as consumers of regulated non-ABS providers. This means that, if the LSB issues guidance on handling first-tier complaints to ARs in relation to their non-ABS roles, LAs

should follow suit (with the necessary modifications). If complaints are made about non-lawyers who are regulated by other bodies, they will be escalated to the OLC, which will refer the complaint to the appropriate body.

Diversity

31. Diversity is a key element of the regulatory objective relating to the shape of the legal profession. ABS may allow different career paths and practices to emerge that may encourage diversity. Demand for diversity will be a constant factor in the modern workplace, so innovative ABS providers may have even greater incentives to operate in creative ways to recruit and retain a diverse workforce. ABS and other legal services providers may, in the future, be required to meet information requirements as part of a broader strategy to increase the transparency of the legal services profession.

International issues

32. Given the consumer protections provided, there is no reason for us to restrict ABS firms from operating internationally. Everyone can benefit from a larger market for ABS. However, other jurisdictions may have the power to limit particular business models from operating in their jurisdiction. The LSB will engage with foreign regulators to increase their understanding of ABS.

LDPs

33. For the same reason, Legal Disciplinary Partnerships ("**LDP**") which have an element of non-lawyer ownership will become ABS. This includes those bodies recognised by the Solicitors Regulation Authority ("**SRA**") and which have up to 25% non-lawyer ownership, as well as those bodies recognised by the Council for Licensed Conveyancers ("**CLC**") which may have a greater proportion of non-lawyer ownership. However, next year following consultation, we propose to seek to modify the legislative framework for LDPs and any other legal service provider that has non-lawyer owners or managers. We currently envisage that, in common with special bodies, such entities will be given a grace period of 12 months, following the introduction of the first ABS in mid-2011, to make the transition to ABS. Those LDPs which have no element of non-lawyer ownership but which do have different types of legal professional managing it (e.g. a solicitor and licensed conveyancer) can continue to be regulated by ARs as LDPs.

Duration and cost of licence

34. It is our view that ABS licences should be unlimited in duration, subject to a requirement to report relevant changes, satisfactory performance of regulatory requirements and an annual broadly cost-reflective licence fee.

Managing overlapping regulation

35. Where an ABS provides regulated non-legal services (e.g. financial advice or accountancy) alongside legal services, there is the potential for overlapping

regulation that can lead to perceptions of inconsistent regulatory requirements or different standards of protection for consumers. This may especially be the case where the requirements on the entity are set by one professional regulator, but requirements on individual professionals within it are set by others. We believe that the basic framework of the LSA 2007 which gives primacy to the LA in the event of such conflicts is of fundamental importance in resolving any confusion, but we nevertheless recognise that regulatory overlaps need to be identified and managed by LAs.

36. We believe that the most effective mechanism to address this issue will be through a single framework memorandum of understanding ("**MoU**") with other regulators to which a LA will have to subscribe. This MoU will be flexible to new models of ABS and new risks as they emerge. The LSB will facilitate the creation of this framework MoU, working in parallel with current ARs and, as a minimum, the main accountancy and property regulators and the FSA.

Proposed outcomes

37. This chapter sets out the outcomes that the LSB proposes for all LAs in their regulation of ABS.

Structure of licensing framework

- Regulation of ABS is based primarily on clear outcomes supplemented by guidance, with rules where there is only one appropriate way to ensure consumer protection and broader public interest.
- A set of core outcomes that apply to all ABS regardless of which LA regulates them.

Behavioural integrity

- Both lawyer and non-lawyer employees, office holders and owners behave in ways that ensure that:
- justice and the rule of law is upheld;
- they act with integrity;
- they act with independence and in the best interests of their clients, ensuring that confidentiality and client money are protected;
- they provide good standards of service to all their clients; and
- they are trusted by members of the public and do not behave in a way that undermines trust in the provision of legal services.

Ownership tests

- Consumer confidence in ABS that are owned by non-lawyers is at least as high as other law firms.
- The process for assessing fitness to own is consistent across all LAs and can be understood by consumers and ABS.
- The tests on owners and their associates are proportionate to identify and manage the risks (if any) posed by them for an individual ABS.

Indemnity and compensation

- ABS provide appropriate levels of redress and protection against negligence and fraud.
- Consumers are properly protected through regulatory requirements for insurance, based on evidence of likely consumer detriment.
- Any requirement for insurance is consistent across all ABS, dependent on the activity being carried out. Individual ABS are able to increase levels of insurance to whatever they consider is appropriate.
- Consumers make more informed choices about the risk they are prepared to take when obtaining legal advice, but the burden of risk is not transferred to them.

- Regulatory requirements for insurance do not unduly restrict commercial decisions about corporate structure, changes to business structure, or closure of business.

Reserved and non-reserved legal services

- ABS provide the same levels of consumer protection for reserved and unreserved legal activities as in the current market.
- Regulatory requirements allow different forms of commercial arrangements for business structures, outsourcing, etc unless the particular circumstances of the case suggest that there is an objective justification based on evidence that it will result in significant consumer detriment.

LA enforcement powers and financial penalties

- LAs' enforcement powers are targeted on areas of high risk and consumer detriment.
- Consumers are confident that their advisors are regulated appropriately.
- LAs' enforcement policies are transparent and take the Statutory Code of Practice for Regulators into account.
- LAs' enforcement toolkit provides an incentive for compliance for all forms and sizes of ABS. In particular, it provides LAs with an effective deterrent that they are able to use flexibly in response to a wide variety of compliance and enforcement issues involving both individuals and entities.

Access to Justice

- ABS provide examples of innovative and flexible ways of providing a greater range of services and enhanced value for money for consumers.
- Consumer awareness and understanding of their right to, and how to get, legal advice improves.
- Consumer trust in the provision of legal services improves.
- ABS provide examples of improving access to justice that can be used by ARs, LAs and the LSB as examples of good practice in improving access to justice in general.

Appellate bodies

- At the start of ABS, a single appellate body to hear all ABS-related appeals.
- The appellate body's costs and processes are transparent, efficient, fair and public.
- The appellate body has sufficient resources and expertise to deal with complex issues.

Special bodies

- Consumer protection and redress for those using special bodies for legal advice is equivalent to those using mainstream ABS.

- LAs adapt regulation and enforcement of ABS to appropriate levels, based on evidence of risk.

HoLP/HoFA

- High quality HoLPs and HoFAs from a wide range of backgrounds and diversity.
- Strong governance arrangements to:
    - provide HoLP and HoFA with access to CEO, Board, non-executives, LA whenever necessary;
    - ensure compliance with LSA and licence requirements;
    - ensure appropriate operating procedures; and
    - provide a mechanism for ABS staff to raise concerns which are acted upon appropriately.
- Commercial decisions (ie not the LA's) form the basis of tests for competence of HoLP and HoFA.
- ABS compliance with licence requirements is high, with minimum enforcement required by LAs.

Complaints handling for ABS

- Consumers of legal services provided by ABS must be afforded the same protections as consumers from non-ABS providers.
- Referral of complaints to other bodies is done in a way that minimises inconvenience for consumers.

Diversity

- ABS allow the provision of legal services to develop in ways that help encourage diversity.
- Better information on diversity allows consumers a clearer insight into the providers they choose, provides individuals the information needed to make an informed decision about their careers and allows law firms to differentiate themselves in a liberalising market.

International issues

- Increased understanding outside the UK of the range of protections afforded by the licensing framework.

Transitional arrangements for LDPs and other similar bodies

- There is a smooth transition for firms that currently have non-lawyer managers or owners who wish to become ABS.

Regulatory overlaps

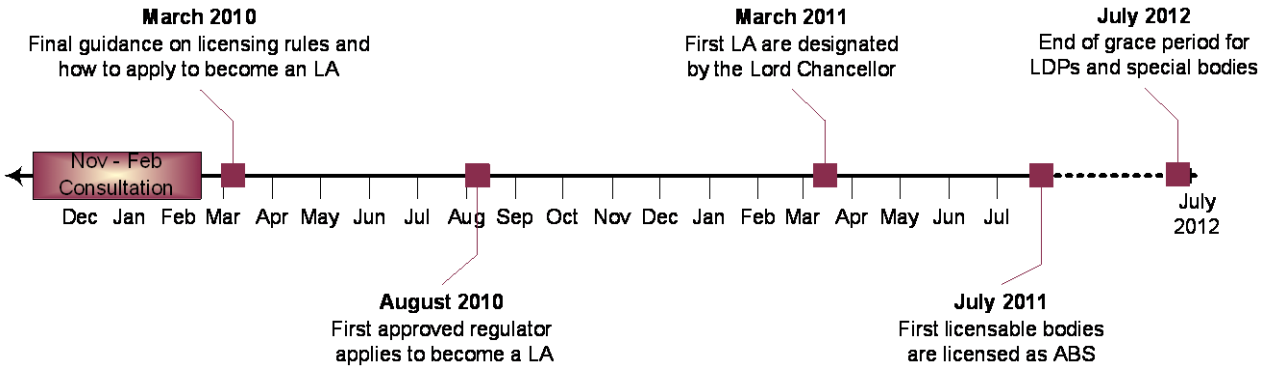
- A single framework Memorandum of Understanding ("MoU") is implemented by all relevant bodies and provides a mechanism to resolve overlaps in ways which:
- provide the best form of consumer protection and redress;
- minimise confusion for market participants; and
- reduce/remove conflict in future.

Next steps

How to help shape our thinking

38. We welcome responses to our consultation document and ask that these be submitted by 5 p.m. on Friday 19 February 2010. For more details on how to respond see page 91. For a list of questions posed in this paper see Annex B.

Timeline



39. Two further related papers will be issued later this year, probably in early December:

    - "Designating approved regulators as licensing authorities"; and
    - "Compliance and enforcement – statement of policy in relation to cancellation of designation as a licensing authority".

40. The first paper will explain how an AR can apply to become designated as a LA. We do not expect all ARs to become LAs and the regulatory ambit of some LAs may be more limited than others. Currently, the SRA and the CLC have expressed a firm interest in becoming LAs.

41. These proposals will be consistent with the approach we will take to approving new ARs on which we have consulted separately and where a decision document will be published in parallel in December.

42. The LSB is also required to make a statement of policy on how it will cancel the designation of a LA. The second paper will therefore explore how this would occur in exceptional circumstances.

43. We consider that publishing these documents in conjunction with the decision on new ARs where there is considerable policy overlap will reduce the burden of those responding to our consultations.

A new approach to regulation - structure of licensing framework

Desired outcomes

- Regulation of ABS is based primarily on clear outcomes supplemented by guidance, with rules where there is only one appropriate way to ensure consumer protection and broader public interest.
- A set of core outcomes that apply to all ABS regardless of which LA regulates them.

Key proposals

- An explicit move to regulation focussed on achieving outcomes.
- A new framework that has a set of common outcomes which apply to all ABS. Achieving those outcomes is for the LA to ensure through its own licensing framework.

Relevant sections of LSA

44. Section 72 defines a licensable body (an ABS). Section 83 and schedule 11 make provisions as to licensing rules. Section 90 sets out the duties of non-lawyers who are employees or managers in an ABS. Section 176 sets out the duty on a person in an ABS to comply with the LA's regulatory arrangements. Section 52(4) deals with conflicts between entity and individual regulation (see Annex A).

Summary of views from Discussion Paper

45. The overall view of respondents was that a robust licensing scheme must be in place before ABS can be licensed.

46. There was a consensus that a proportionate but tough licensing regime was required for what they perceived as 'high risk' ABS together with adequate review and monitoring processes. However, respondents generally did not provide specific examples of models that they thought were high risk.

47. The responses were generally supportive of a move to an outcomes based approach to regulation expressed as principles. There was some concern about whether the approved regulators would be able to appropriately understand the risks posed by complex legal service providers and regulate them proportionately. Some respondents thought that a move to regulating on outcomes for ABS rather than concrete rules may lead to a low uptake of ABS. There was recognition that more prescriptive rules may be required in some instances.

48. Many respondents pointed to the need for a 'level playing field' in licensing and regulating ABS and non-ABS firms so that there is no disparity in treatment between types.

49. Many respondents thought that the proposed timetable was very challenging but on the whole they thought it was necessary. A few thought it was too slow.

50. Consumer groups, but also some ARs, were of the view that consumers must be confident that licensing procedures will protect their interests when ABS apply and thereafter.

51. Most thought that the LSB should only step in to be a direct licensor as a last resort but that the LSB also needs to communicate that it is prepared and ready to do so in terms of resources.

Discussion

Regulating for consumer focussed outcomes

52. A focus on outcomes enables effort to be directed at delivering quality legal services that are tailored to consumers' needs. Rather than a detailed set of rules that need to account for every possible permutation of adverse behaviour, principles allow the outcome to be clearly articulated. Regulated firms then have the flexibility to determine how they meet those outcomes. This approach requires more sophisticated regulation that moves away from an assessment of whether a rule has been followed and moves towards assessing whether the actions being investigated are likely to achieve the desired outcomes. This approach helps to ensure that regulation is adaptable, targeted and consistent.

53. We consider that the introduction of ABS provides an opportunity to simplify existing regulation to the benefit of consumers and current firms as well as new entrants. Transferring the existing regulatory framework (with any necessary amendments to take account of the Act's requirements) and then proceeding to amend it over an extended period of time may lead to a situation where new entrants decide to delay entry until the regulatory framework is stable, rather than build systems on one basis now and migrate from them in future.

54. We do recognise that in some instances relying solely on outcomes or principles will not be appropriate. In these cases, rules will be required. In some cases it will also be appropriate for the LA to provide guidance to ABS. However, that guidance should not be seen as mandatory (since it would then be a rule); it may describe one way of achieving the desired outcome but that may not be the only way to achieve it.

55. We do not wish to create a framework in which some LAs are seen to have "weaker" ABS regimes than others or which strive for different (and possibly conflicting) outcomes. We consider that this will cause confusion for

consumers and for new entrants. We therefore propose to create a set of general outcomes that will apply to all ABS, regardless of LA.

56. We would then expect that each LA will develop its own approach to regulating to achieve these core outcomes. In some instances they will identify that specific rules are required; appropriate levels of non-prescriptive or interpretive guidance may also form some part of a LA's compliance framework. And the professional representative arms of ARs may also have a role in providing additional guidance. In addition to how it will regulate to achieve the core outcomes, we expect the LA to make explicit details such as the licensing process it will follow, its approach to compliance and enforcement and professional development requirements. However, we do not consider that it would be appropriate for LAs to seek to use that process to simply replicate their current approach to regulation.

57. It would also be possible, if there are specific evidence-based concerns about a particular ABS which are not sufficient to justify withholding authorisation, to introduce individual proportionate requirements in that entity's licence on a precautionary basis. (Our preferred approach to licensing special bodies (outlined at page 65) could be accommodated through this route.)

58. This approach would also facilitate new entrant LAs since they would know for what outcomes they would be regulating. It would also mean that, in the event that the LSB has to become a direct licensor, the focus of its regulation would be on the same outcomes as other LAs. This, in turn, may reduce the uncertainty faced by potential ABS if it appears that none of the existing ARs will be designated as competent LAs by mid-2011.

Applying outcomes to individuals and entities

59. The regulation of legal services has, to date, been achieved largely through the regulation of individual professionals through their personal professional code of conduct. This has led to the situation where failure to comply with issues such as forms of business structure, organisational filing systems and diversity duties can be considered to be matters of professional misconduct.

60. This approach has provided consumers with a degree of protection but does not provide a strong route for addressing systemic concerns. There has, therefore, been a move in legal regulation, as well as elsewhere, to understand the role that the entity in which the individual practitioner operates plays. The LSA 2007 makes it clear that regulators will be expected to regulate the systems and behaviours of the entities in which the legal services are provided. This should lead to approved regulators placing greater emphasis on a business' governance, capability and management competency.

61. The Act states that in cases where there is a conflict between entity rules and individual rules, those of the entity prevail. We have considered what might be an appropriate balance between those issues that it seems more appropriate to regulate on an entity basis and those which are more appropriate to individuals (although in some cases there is an overlap between the two). Both can be regulated using an approach based on outcomes.

62. Entity level considerations are likely to include:

- ownership;
- corporate governance;
- some HR issues such as training for all staff as well as specific professional development requirements;
- finance issues such as requirements for handling client money;
- consumer-facing requirements such as complaint handling, clarity of charges;
- minimum insurance provisions;
- some policies that concern adherence to the professional principles (including conflict of interest, duty to the court, independence of lawyers);
- conduct issues – in particular compliance with the requirement of the Act to ensure that non-lawyer managers or employees of an ABS do not do anything that compromises compliance with the duties of lawyers;
- general requirements (for example, on specification of place of practice and provision of information to the LA); and
- anti money laundering processes.

63. Entity level considerations are less likely to include:

- business strategy, planning and reporting;
- wider HR issues such as recruitment and retention policies;
- wider finance issues such as systems and financial viability;
- information management; and
- promotion and marketing strategies

64. Individual behaviour is likely to be influenced by the culture of the entity, but some issues that might focus more on individual behaviour are:

- professional ethics;
- personal conflicts of interest;
- professional interactions;
- acting in the client's interest;
- duty to the court;
- viability and reputation of the profession;
- professional training and development; and

- ensuring the entity they work within meets the standards required.

65. With the removal of restrictions on who can work together, individuals of different types (solicitors, legal executives, barristers etc. and non-lawyers; accountants, doctors, surveyors etc.) will be allowed to work together in the same entity. Each of these groups has their own codes of conduct and their own rules. The new framework will allow different professionals to work alongside each other with a clear consistent operating environment being overseen by the regulator of the entity.

66. We consider that there is additional advantage in such a demarcation of entity/individual where there are regulations from other professions or industries applying to an organisation. By clearly stating the individual requirements on the regulated lawyer, the entity will also be required to facilitate the person's adherence to them. The entity level requirements can then be considered alongside the other requirements made by other regulators providing a path through what might otherwise appear to be a regulatory maze (see page 89).

67. The advent of ABS will mean that non-lawyer managers will have a degree of control over the organisational environment in which authorised persons will operate. To ensure this environment is conducive to meeting the regulatory objectives the entity will need to be regulated directly. This will also align the regulation of the business to the control of the business. There is increasing evidence that good quality systems and processes lead to the best compliance.

68. The requirement in the Act that managers and employees who are not lawyers must comply with licensing rules and must not do anything that contributes to a breach of licensing rules adds an additional safeguard to prevent undue pressure being exerted on lawyers in an ABS. The Act gives strong incentives to prevent this happening: the individual who subjected the authorised person to the pressure would be in breach of the Act, the entity would breach the licensing rules for not having processes in place to detect and prevent it and the HoLP would have a duty to report it to the LA (and would be in breach as well for not identifying and preventing it).

Question 1

What is your view of basing the regulation of ABS on outcomes?

a. Should all LAs have the same core outcomes?

b. Are the proposed outcomes appropriate?

c. Is the division between entity and individual regulation appropriate?

Ownership tests

Desired outcomes

- Consumer confidence in ABS that are owned by non-lawyers is at least as high as other law firms.
- The process for assessing fitness to own is consistent across all LAs and can be understood by consumers and ABS.
- The tests on owners and their associates are proportionate to identify and manage the risks (if any) posed by them for an individual ABS.

Key proposals

69. A test of probity and financial position for all owners of ABS (lawyers and non-lawyers) that is consistent across all LAs. This will consist of a declaration of any criminal convictions and pending cases, and any disciplinary action whether completed or not. This must be checked, where possible, by the LA. The test for financial position must require a declaration of any insolvency, individual voluntary arrangement (IVA) or undischarged bankruptcy

70. The external ownership tests required by the Act must be implemented in a proportionate way to ensure that they do not unduly restrict different types of ABS ownership. We consider that in most cases, people with significant influence are unlikely to have a negative influence on an ABS. We consider that the requirements set out in the Act are designed to ensure that, as far as possible, people with improper significant influence are detected. However, the requirements for good governance and transparency of ownership that we discuss in this paper are at least as important in helping to ensure a proper level of consumer protection.

71. There should not be a requirement to undergo fitness to own tests regularly. But there must be a licence condition that requires the ABS to notify the LA of any changes of ownership and/or issues that arise. It will then be for the LA to assess what action, if any, is needed.

72. There should be no limit on external ownership – i.e. ABS can be 100% externally owned. Licensing rules must not prohibit the flotation of licensed bodies on a recognised investment exchange.

73. Any listed ABS must make a clear statement in its constitutional documents of the regulatory duties that apply to its commercial activity by virtue of being a regulated services provider. The principle must be that a duty to a shareholder or other stakeholder does not compromise the duties owed to the court and to a client. LAs should consider whether this should also be required for other ABS.

74. The LSB does not consider that it is appropriate for a LA to widen the test for a restricted interest by defining a "controlled interest".

Relevant sections of LSA

75. Schedule 13 (Ownership) makes provision about the holding of certain interests in licensed bodies by non-authorised persons. Sections 90 and 176 create duties on lawyers and non-lawyers not to cause breaches of licensing rules.

Summary of views from Discussion Paper

76. Some respondents considered it was important to make the distinction between ownership and management. There was support for the idea that those with a controlling interest in an ABS would be subject to a greater level of scrutiny due to the importance of understanding who has ultimate control of the business. There was general agreement that a fitness to own test offers a degree of assurance but that there is a need to ensure that each ABS has the appropriate processes and procedures in place. A small number of respondents commented that fitness to own is more of an issue if non-lawyers are in the majority. However, other respondents said that they did not share this view. A number of respondents thought that a clear hierarchy of duties within the licensed body would be important to ensure that those providing legal services had an ethical duty to their client (in the same way solicitors are required to under the code of conduct), although responses did not contain specific comments on what the hierarchy of duties should look like.

Discussion

77. Consumers need to feel confident that legal services obtained through an ABS are of at least similar quality as those obtained through conventional law firms. Concern has been expressed by some that external ownership and non-lawyer management may increase the risk that a lawyer's independence and adherence to their professional principles is compromised (leading to lower quality advice). The LSA 2007 therefore sets out a detailed framework for identifying which external owners of an ABS must be subject to a "fitness to own" test.

78. The aim of this guidance is to make the detailed prescriptive legislation work well for all parties: LAs, legal services providers, investors, consumers and the public more generally. In developing this guidance we have tried to prevent excessive overlap and/or duplication of effort by regulators. We have therefore taken into account the requirements that the FSA, Gambling Commission, accountancy organisations and the National Lottery Commission have introduced.

79. The LSA 2007 states that a non-lawyer who holds a "restricted interest" in a licensed body must be approved by the LA as a fit and proper person. A restricted interest is defined as either a:

- "material interest" (an interest of 10% or more in a licensable body or a body which controls a licensable body); or
- a "controlled interest" (which can be specified by a LA but must be a greater percentage than 10%).

80. The LSA 2007 states that a person is allowed to hold a restricted interest if three tests are passed:

- the holding does not compromise the regulatory objectives set by the LSA 2007 - (the "**regulatory objectives test**"); and
- the holding does not compromise the ability of any employee or manager of the ABS to comply with its regulator's code of conduct and/or a LA's rules – (the "**regulatory person's duties test**"); and
- the person (and their associates) are otherwise "fit and proper" to hold that interest – (the "**fitness to own test**").

Guidance on regulatory objectives test

81. As part of its licence application, an ABS must identify in its application any non-authorised person who is subject to the fitness to own test. LAs must require those applying for a licence to identify any issues that they consider may compromise the regulatory objectives. This should include identification of anyone holding a material interest that is subject to other duties which may conflict with the regulatory objectives and the steps they have taken to avoid creating a material conflict of interest.

82. LAs should take the broad approach that generally ABS will make the achievement of the regulatory objectives more likely. The opportunities presented by external investment and greater freedom to innovate may enable ABS to be more adaptable to consumers' needs whilst at the same time providing high quality advice and information. We do not consider that it would be appropriate to seek to assess whether an ABS will *enhance* any of the objectives, although an individual firm may want to present information on this issue.

Guidance on the regulated persons' duties test

83. The LSA 2007 provides significant protection for managers and employees in an ABS from any external owner or non-lawyer who sought to try to influence them in order to compromise their independence or their adherence to professional principles or licensing rules. It creates a duty for both lawyers and non-lawyers within the ABS not to do "anything which causes or

substantially contributes to" a breach of the requirement (under sections 90 and 176 of the LSA 2007) to comply with their regulator's code of conduct and/or a LA's rules.

84. The Act includes in the HoLP's duties a requirement to report any failure to comply with these duties to the LA. If the owner is found to be no longer 'fit to own', then the LA has the power to divest them of their shareholding. An owner can also be placed on the LSB's list of people who are subject to objections and conditions. This should mitigate the risk of any owner trying to inappropriately influence any of the employees of the ABS.

85. We consider that it is proportionate for a LA to require a listed company to set out a formal hierarchy of duties in its constitutional documents. This must be a clear statement of the regulatory duties that apply to its commercial activity by virtue of being a regulated legal services provider. The principle must be that a duty to a shareholder or other stakeholder does not compromise the duties owed to the court and to the client. LAs may want to take a similar approach to the constitutional documents of other forms of ABS.

86. In Australia, further protection was afforded to Slater and Gordon (a law firm that floated on the Australian stock exchange) by introducing into its constitution a condition that, in appropriate circumstances, a shareholder's shares were to be redeemed by the company for the price they were originally purchased if that shareholder was deemed not fit to own. This measure ensured that divestiture could happen easily; it may be appropriate to introduce a similar sanction for ABS. However, it may be also appropriate to consider whether buying the shares back at the price paid is appropriate if the share price has fallen.

Guidance on the fitness to own test

87. The LSA 2007 requires that, when it decides whether a person who is not an authorised person is fit to own an ABS, a LA must have regard to, and explain the procedures that will be applied, to assess:

- the person's probity and financial position;
- whether the person is included in the 'disqualified list' or the list recording information on action taken against certain persons, that the Act requires the LSB to keep;
- the person's associates; and
- any other matter which may be specified in the licensing rules.

ABS owners

88. In order to ensure consumer confidence in all forms of ABS, the LSB's preferred approach is that there should be a uniform test based directly on the requirements of Schedule 13 to the Act, for all owners of an ABS, whether

they are lawyers or non-lawyers. We do not consider that it is appropriate that just because a person is an authorised person, neither they nor their associates are subject to these tests. We also consider that this test for fitness should be consistent across all LAs in order that ABS regulated by one LA are not perceived to be riskier than those regulated by another LA. We also propose that the ultimate beneficial owner of an ABS should always be declared and that this information should be made public.

89. Licence applicants must identify the people or entities that are subject to the fitness to own test and state the type of restricted interest they hold. We propose that all ABS licence applicants must be required to declare whether their owners have been subjected to:

- any criminal convictions or cases pending in the UK or elsewhere;
- any disciplinary action taken by a professional body in the UK or elsewhere, whether concluded or not;
- whether the owner has ever been disqualified as a director;
- whether the person has ever been adjudged bankrupt or been made the subject of an insolvency voluntary arrangement; and
- any other material information that might have a bearing on their fitness to own the ABS.

90. We propose that there should also be a requirement to agree that all the information provided can be checked with other bodies. Where possible, LAs should check the veracity of the information provided on criminal convictions and disciplinary action. They should also establish formal information sharing powers between themselves and other professional bodies and regulators about disqualified people and disciplinary action. It may be appropriate for the framework Memorandum of Understanding that we proposing (see page 89) to address this issue. LAs must publish the criteria against which they will assess the outcomes of these checks and how they will be taken into account in making a decision whether to grant a licence.

91. LAs must, as an additional safeguard, have a licence requirement to notify material changes in character and suitability of people subject to this test. We do not, however, consider it necessary for annual checks to be carried out on ABS owners. The ability for the LA to impose financial penalties and, ultimately, to revoke an ABS licence is likely to act as a significant deterrent to failing to provide it.

92. LAs must explain how, in considering any adverse information from this test, they will assess it against the individual's role in the ABS. We consider that LAs should have the flexibility to disregard, for example, minor convictions. In other cases, licence conditions rather than disqualification may be

appropriate. However, we expect LAs to refuse to authorise any individual who knowingly makes a false declaration.

93. We consider that these approaches are acceptable and manage the risk of improper people having undue influence over the provision of legal services. However, some of the responses to the Discussion Paper expressed concern at the management competence of lawyers and the lack of emphasis on assessing this competence when determining the character and suitability of authorised persons. We consider that management competence is a commercial matter for individual ABS to determine (subject to the Guidance at page 69 about HoLP and HoFA). It is not appropriate for LAs to consider this as part of their licensing process. However, a self-assessment process for management competence at an entity level has produced positive results in Australia and may be useful as part of an approved regulator/LA toolkit for identifying high risk entities. We will be discussing this further with relevant parties.

A non-authorised person's "associates"

94. The LSA 2007 requires LAs, when considering whether a non-authorised person with a material interest ("**A**") is fit to own an ABS, to have regard to:

- an "associate" of a person who holds a material interest ("**B**"); and
- a person together with their "associate(s)" who jointly hold a material interest ("(**A+B**)").

95. Where "B" or "(A+B)" are determined to hold material interests, they then become "A" and the fitness to own test needs to be determined once more (so far as the new category of associate has not already been tested). The rationale for this formulation is to capture the chain of ownership. The rationale for the choice of categories in "B" is that those categories may exert inappropriate influence over "A" by virtue of their relationship.

96. The category of "B" includes a very wide range of classes of relationship – including:

- various family relations of A;
- an undertaking of which 'A' is a director;
- an employee of A;
- if A is an undertaking – (i) a director of A, (ii) a subsidiary undertaking of A, or (iii) a director or employee of such a subsidiary undertaking (where A is the person); and
- a partner of A (except where a shareholding in A is itself a partnership e.g. a 15% shareholding – 5% owned by one party and 10% owned by another – the 10% party would be subject to the fitness to own test but the 5% party would not).

97. For the avoidance of doubt, only a person holding a shareholding or voting power in a licensed body can have an associate. So an employer will not be subject to the fitness to own test simply because some of its employees have a material interest (e.g. "X", "Y" and "Z" each hold 4% shareholdings in an ABS, and they all work for the same employer, "W", who holds no shares).

98. One possible interpretation of this part of the Act is that the ownership test itself only ever applies to person 'A' rather than to them and to every one of their associates.

99. On a more restrictive reading of the Act, it appears that many associates could be caught, and associate companies will have to ask employees about their shareholdings. The process of identifying the associates and of notifying the LA before a change of control could be burdensome for some businesses. In many instances, the ongoing exercise of identifying all employees and undertakings and employees of undertakings who buy shares in the licensed body (or who propose to buy shares in the licensed body when the body is first licensed) may be complicated, expensive and disproportionate. However, it is more practicable for a business to make such a declaration than for a LA to undertake an investigation before granting a licence.

100. We have assessed the likely regulatory burden (on the ABS and on the LA) if a LA were to require information about every associate caught by the definitions in the LSA 2007. We are aware that some institutional investors and banks may be particularly affected by this. Our assessment is that the:

- impact on partnerships/private companies with an uncomplicated group structure and/or small membership: medium;
- impact on partnerships/private companies with a complicated group structure and/or large membership/ other low risk bodies: high; and
- impact on public companies/listed companies: high.

101. The challenge therefore is to define arrangements which incentivise as full disclosure as possible without being unduly burdensome, such that a knowingly false or unreasonably scanty declaration by a firm can legitimately lead to cancellation of a licence. The LSA 2007 requires the LA to "have regard to" associates and it may be that the following approaches are appropriate to satisfy this requirement:

'De minimis' levels

102. If a person may become subject to a test because they are an associate of someone who owns at least 10% of shares in the ABS, and the associate owns an insignificant amount (say one share in a corporate ABS with no voting rights attaching to it), the LA could take a pragmatic approach and introduce a *de minimis* level before the associate is subject to the test. This

could be a threshold of 3%, based on thresholds used by, for example the Disclosure and Transparency Rules or the Gambling Commission.

Presumptions as to fitness to own

103. A LA may wish to include in their rules a presumption that certain categories of associate (for example certain types of institutional investors) are fit to own, unless they appear to be acting in concert with each other.

Licence requirements in certain cases

104. If a LA identifies a particular risk in terms of an owner's associates, it may be appropriate to require the ABS (by imposing a licence condition) to identify any parties that might be able to act in concert and to monitor their behaviour (with appropriate record keeping) and report any concerns to the LA.

105. These risk-based approaches could enable more effective targeting of LA resources in pursuing fitness to own tests in certain scenarios or for certain people (along with the exercise to identify those people).

An additional approach

106. The requirements in the Act are designed to try to identify people who may try to use their influence to achieve outcomes that would conflict with the regulatory objectives or compromise the duties of lawyers and non-lawyers in an ABS to comply with its licence requirements. However, we consider that there are limitations on whether this can always be achieved in practice, and that there should not therefore be an over-reliance on the results of these tests (either by LAs or consumers). That in turn means that tests should not be overly prescriptive and burdensome in relation to people who give no cause for concern. Rather, it is likely to be appropriate for LAs to ensure that they have the capability to react rapidly if they acquire information suggesting improper influence and to introduce supplementary requirements for an ABS that they identify to be higher risk. These might include a requirement for transparency about who the ultimate beneficial owner is and enforceable covenants between an ABS and a "person of influence" that require them not to exercise that influence, with a duty to inform the LA of any attempt to breach the requirement.

107. We would also expect LAs to take into account the requirements on listed companies to identify those who own 3% or more of shares in line with the reporting requirements of the FSA. It may be that it is unnecessary for LAs to go beyond this requirement, given that the information is in the public domain and is subject to the scrutiny that brings. This level is also unlikely to constitute a voting block that can influence the ABS without raising concerns.

Other specific issues

Restricted interests

108. The LSA 2007 permits a LA to specify a category of 'controlled interest' within the category of 'restricted interest' and in addition to the definition of material interest. Given the extent of the definition of "material interest" and the other protections offered by the Act, the LSB does not consider that it would be proportionate for a LA to define any category of controlled interest, unless it can provide an objectively justifiable reason (with appropriate evidence) for doing so.

Decreasing the material interest percentage

109. Additionally, the LSA 2007 gives a LA the ability to decrease the percentage at which an interest becomes material to less than 10%. The definition of a person holding a 'material interest' already includes eight categories of material interest and is already very wide in its scope. We would not, therefore, consider it appropriate for licensing rules to define 'material interest' at a percentage less than 10% unless a LA can provide an objectively justifiable reason (with appropriate evidence) for doing so.

Partners having a material interest

110. The LSA 2007 also gives a LA to specify that *any* partner in a partnership has a material interest in that partnership, whether or not they have a material interest as defined in the LSA 2007. Since the definition of material interest already includes someone who is able to "exercise significant influence" we would not consider an extension of this sort to be appropriate unless a LA can provide an objectively justifiable reason (with appropriate evidence) for doing so.

Extent of external ownership

111. Licensing rules may specify that a licensed body may not have non-authorised persons holding an aggregate shareholding above a specified percentage (and that percentage may be different for shares held in the licensed body and shares held in a parent undertaking of the licensed body). We consider that this matter is a commercial one for the ABS and therefore do not consider that there should be any limit imposed by the LA, nor any other similar restriction (e.g. on sharing profits). For similar reasons, we do not consider that licensing rules should prohibit flotation of licensed bodies on a recognised investment exchange.

Continuing notification requirements

112. It is likely that the liquidity of shares will be affected by the requirements in the LSA 2007 to notify a LA of a proposal to acquire an interest or option in an interest *before* the acquisition itself. The Act requires that a licensed body and LA must be notified whenever an investor 'proposes to take a step' which

results in acquiring a restricted interest. We recognise that in certain circumstances the liquidity of the shares may be particularly important and may be materially affected by this requirement.

113. In order to minimise the impact of this requirement on commercial decisions, one option would be for the LA to carry out the fitness to own test on an expedited basis. However, this approach would not remove the impact on the liquidity of shares. Another option would be to use the provisions in the Act for conditional approval of a notifiable interest. It might be appropriate for there to be a licence condition for floated ABS that gave all new shareholders of a notifiable interest conditional approval for a set period during which time they would have to pass the relevant fitness tests. An ABS constitution could include a right for it to divest the new owner of their shares if a person does not meet the fitness to own test and this may give comfort to a LA in including this conditional approval in advance.

Foreign ownership

114. As a principle we would not expect foreign ownership of law firms to be restricted, but recognise that special conditions may need apply where the owner may benefit from legal immunity (e.g. in a sovereign wealth fund context) or has no address for service in England or Wales. We also recognise that, in some circumstances, foreign ownership may result in a higher risk profile and/or greater investigation costs, which we believe should be reflected in a differential application fee and in the annual licence fee. The proposed requirement that all ultimate beneficial owners must be declared and that the information must be made public may also help to identify any specific risks. The LSB believes that this is proportionate, and that is it not appropriate to ban certain categories of foreign ownership of ABS.

Question 2

Do you think our approach set out in this Chapter to the tests for external ownership is appropriate?

a. Should the tests be consistent across all LAs?

b. Is our suggested approach to the fitness to own test the right one?

c. If declarations about criminal convictions are required, should these include spent convictions?

d. What is your view of our suggested approach for considering associates? Is there an alternative approach that would work better in practice?

e. Should there always be a requirement to declare the ultimate beneficial owner of an ABS?

f. Overall, are any modifications needed to ensure that our approach work in a listed company?

g. Overall, are any modifications needed to ensure that our approach work in very small companies?

h. Do you think that the definition of restricted interest should change?

i. Do you think that covenants should be required from those identified as having a significant influence over an ABS?

j. How should the LSB respond to the information it receives about information on action taken against people that falls short of disqualification?

Indemnity and compensation

Desired outcomes

- ABS provide appropriate levels of redress and protection against negligence and fraud.
- Consumers are properly protected through regulatory requirements for insurance, based on evidence of likely consumer detriment.
- Any requirement for insurance is consistent across all ABS, dependent on the activity being carried out. Individual ABS are able to increase levels of insurance to whatever they consider is appropriate.
- Consumers make more informed choices about the risk they are prepared to take when obtaining legal advice, but the burden of risk is not transferred to them.
- Regulatory requirements for insurance do not unduly restrict commercial decisions about corporate structure, changes to business structure, or closure of business.

Key proposals

115. A number of issues have been identified in the current arrangements that are wider than ABS, including very high requirements in the SRA's "minimum terms", a single renewal date and the operation of the Assigned Risks Pool ("**ARP**"). We recommend that these are considered as soon as possible by interested parties

116. For ABS we have identified some key issues that need to be resolved:

- What the requirements for Professional Indemnity Insurance ("**PII**") will be when an ABS undertakes a range of activities
- Run-off and successor practices – the current arrangements may act as a barrier to ABS
- Compensation funds – whether it is appropriate to require them and how they could work in ABS providing a range of different types of advice

Relevant sections of LSA

117. Section 83 (5) (d) and (e) stipulate that licensing rules must contain appropriate indemnification and compensation arrangements.

Summary of views from Discussion Paper

118. There was general consensus that ABS should be subject to the same indemnification and compensation requirements as for non-ABS firms.

119. A further general view was that arrangements must be put in place to ensure that consumers are protected but bodies must be free to adopt whatever cover arrangements are suitable.

120. The Land Registry commented that certain large organisations would not necessarily need to hold the same level of insurance cover given their levels of financial liquidity but that this would need to be properly assessed and monitored.

121. Respondents thought that the LSB should set core standards for indemnity cover and compensation. Significant differences from the current arrangements would create an unlevel playing field. They considered that there is a danger that compensation funds penalise well run firms for the wrong doings of other firms.

122. The SRA did not believe that external ownership by 'fit and proper' non-authorised persons should lead to insurers viewing the risk of civil claims against an ABS as being very different from the risk in traditional solicitor firms.

123. The Society of Scrivener Notaries said in their response that they would be opposed to any attempt by a LA to set requirements for ABS that are lower than those required of notaries in the non-ABS environment.

Discussion

124. While insurance may, to some, appear to be a technical and prosaic topic it is vital to ensure that consumers can be compensated when things go wrong, and the approach and design of the insurance arrangements will have a profound effect on the way the market will develop. Insurance concerns managing risk. The main type of risk that these insurance provisions insure against is negligence. In addition, some ARs operate compensation funds to provide recompense to consumers who have suffered loss due to fraud.

125. There are currently three different models of PII:

- mutual self insurance throughout the profession;
- a single master policy that covers the whole profession; and
- individual firms taking on individual insurance subject to minimum terms

126. The three largest ARs have chosen one of these approaches each. The SRA requires firms to be individually insured, the CLC manages a master policy that insures all licensed conveyancers, and self-employed barristers are required by their Code of Conduct to self insure through the Bar Mutual Indemnity Fund.

Current arrangements

127. This chapter does not consider in detail all the arrangements of all the current ARs and the impact of ABS on them. Rather, it seeks to highlight some issues

that we have identified that may be problematic for ABS and that may be common to some or all ARs.

PII

128. Solicitors and many other lawyers are required to have PII in order to practise. Licensed conveyancers' insurance is provided by a Master Policy. For solicitors, PII is provided by "qualifying insurers" (i.e. insurance companies who provide insurance that meets terms specified by the SRA). If no qualifying insurer will offer PII then a solicitor can obtain last resort cover from the ARP at a much higher premium than the market rate. The ARP is covered by qualifying insurers in proportion to their share of the total premiums paid by all solicitors. The SRA requires all those it regulates to renew their PII on 1 October every year. Corporate law firms must have at least £3m cover, other firms and sole partnerships at least £2m. The CLC has negotiated a Master Policy with an insurer. Licensed conveyancers pay a base premium of 5.25% of turnover for domestic conveyancing and 13.5% for commercial conveyancing a year. Other professionals (e.g. accountants and financial advisers) are also required by their regulators to have PII.

129. PII is always provided on a "claims made" basis. This means that the insurance policy against which a consumer claims is the one providing cover when the claim is made, not when the actual event occurred. In some cases there may be many years difference.

130. There are currently differences between the levels of cover required by each AR as well as differences in the type of events that are actually insured as the table overleaf shows.

	SRA	CLC	ICAEW	ACCA	ICAS
Minimum PII any one claim	£2m (individual) £3m (corporate)	£2m (entity)	2 ½ x fees, subject to minimum £100k (£500k to £1.5m for probate)and maximum £1.5m	Depends on total annual fee income. Minimum: £100k (for probate) to larger of 25 x largest fee or £1 million	2 ½ x fees, subject to minimum £100k and maximum £1.5m
Permitted excess		Min £3.5k	Max £30k per principal in the firm	Lower of £20k per principal and 2% of level of indemnity	Max £30k per principle in the firm
Covers:					
Negligence	✓	✓	✓	✓	✓
Acts, errors, omissions	✓	✓	✓	✓	✓
Breach of duty	✓	✓	✓	✓	✓
Civil liability	✓	✓	✓	✓	✓
Fraud	✓	✓	✓	✓ (Fidelity Guarantee Insurance)	✓
Payment of excess by insurer	Yes	No	No	No	No

131. For solicitors, if a law firm wishes to close down or a partnership ends, the SRA requires solicitors to buy run-off cover at the point of closure to indemnify against claims that might be made in the six years after that date. (Claims made after that time are made against the Solicitors Indemnity Fund.) There is no requirement to buy run-off cover if there is a "successor practice" because the successor practice is required to provide PII for claims made against the previous firm. The Solicitors' Code of Practice provides guidance on which

firm is likely to be considered the successor practice. Run-off cover typically costs two and a half to three times the most recent PII premium. This constitutes a significant exit cost.

132. With effect from 1 July 2008, the CLC has made arrangements for closing licensed conveyancer practices to be offered run off insurance cover with the Master Policy underwriters (replacing the CLC's run off block policy). This provides a six year extension of cover in return for a single premium upon similar terms to the Master Policy cover. The CLC currently provides a contribution to the premium.

Compensation funds

133. Compensation funds are held by the Law Society (which has a minimum reserve of £29m) and the CLC (currently £3.1m as at December 2008 with a minimum reserve of £2m).

134. For solicitors, there is a requirement to pay a variable amount each year (currently £390) into the compensation fund (this is lower if the firm does not hold client money). For licensed conveyancers the amount is £25 for employed members and 1.5% of turnover for entities. They are used to compensate consumers in cases where an authorised person has been dishonest and so the PII insurer will not pay a claim. Compensation payments may take some time to be made (up to 18 months) but in some cases such as conveyancing, if the SRA has intervened to close down the firm, money can be paid very quickly to ensure that properties can be bought and sold as planned.

135. Grants may be made out of CLC's compensation fund to relieve or mitigate losses suffered as a result of the negligence or dishonesty of a licensed conveyancer or a CLC regulated recognised body.

Issues raised

136. A number of issues were identified with the current arrangements. While these are not, strictly speaking, ABS-specific issues it is our view that these should be considered and contribute to the development of indemnity and compensation arrangements for ABS.

Required terms

137. The very high "minimum" terms that are required by the SRA may cause some insurers to decide not to offer PII, thereby increasing the price overall, which is ultimately paid by consumers using legal services. In addition, the requirement for insurers to pay any excess (in circumstances where the lawyer cannot or will not pay) may reduce the incentive on lawyers to feel responsible for paying an excess in the event of a successful claim (although insurers do sue solicitors for non-payment of the excess). It may also create

an incentive on the lawyer to increase the level of the excess in order to lower premiums which, in the event of non-payment of the excess, exacerbates the issue (although insurers may check the solicitor's ability to pay any excess before they agree to increase the excess).

138. As part of the research for this document the Association of British Insurers (ABI) undertook a survey of the solicitors' PII market. The survey focussed on closed, paid claims over three insurance years beginning October 2005. The ABI estimates that for the three years there were approximately 8500, 9500 and 10000 claims for the years 2005/06, 2006/07 and 2007/08 respectively. For the claims they were able to get information about, 98.5% of claims were for less than £100,000, 1.4% of claims were for between £100,000 and £1m, and 0.1% of claims were for over £1m. For the survey period there were no claims closed against sole practitioners over £1m and only about 0.08% of claims made against firms with 2-10 partners were at that level. Perhaps unsurprisingly, the largest claims were made for legal work described as "commercial" with 8% of closed claims being between £100,000 and £1m and 1.7% of claims being over £1m. Personal injury claims on the other hand, were only larger than £1m in less than 0.1% of cases and between £100,000 and £1m in less than 1% of cases. It should be noted that while this survey is interesting there are several limitations and it can only be a preliminary indication of the insurance market. The information provided does not represent the full cross section of the market (it represents between 60% and 68% of the market); it also does not take into account that smaller claims usually get closed more quickly than larger claims so larger claims may be underreported in this survey. We will be working with the ABI, insurers and the SRA to undertake further analysis of the PII market.

139. There are different requirements between the existing ARs and between ARs and those who regulate those who may join ABS. ABS carrying out a variety of different activities are likely to create different levels of risk to those currently in the market. So it may not be appropriate to simply carry across the current requirements into ABS.

140. The SRA's requirements for all PII to be renewed on 1 October may present logistical problems for ABS since it may prove difficult to get insurance from the desired start date of mid 2011. We do not want potential ABS to be constrained in deciding when to enter the market by the requirements of a regulator's administrative processes. In addition, it seems currently that a single renewal date may lead to increased numbers of firms having to rely on the ARP. We welcome the SRA's intention to consult on introducing rolling renewal dates. It is unlikely that we would agree to licensing rules that forced a single renewal date.

SRA's run-off requirements and successor practice rules

141. The SRA's run-off requirements raise a number of issues that may affect ABS but also have wider implications. In the absence of a "successor practice" (as defined in the SRA rules), the SRA requires a law firm that wishes to close to provide 6 years' run-off cover. This provides insurance for claims that are made after the firm has closed. If there is a successor practice, that firm is required to provide insurance for claims made against the previous firm. Run-off insurance typically costs the equivalent of two and a half to three years' premiums. It may therefore be expensive for a law firm to close in an orderly way. While these arrangements are intended to provide consumer protection this might encourage those who do not really want to continue practising to do so even though they may not be providing a good quality service to their clients. Or it might encourage those who decide to exit, to just walk away without the expense of buying run-off cover, leaving liability to pay claims in future years with the compensation fund (paid for by other solicitors). It may also provide a perverse incentive on insurance companies not to tell the SRA about firms they have concerns about because if they are subsequently closed down by the SRA, the insurance company has to provide the run-off cover even though there is no one to pay the premium.

142. It may also be expensive for a law firm to merge, change its partnership or status or make other significant changes. Whilst some of these costs are likely to be part of the normal commercial considerations involved in business decisions, others may arise solely from the requirements of the regulatory regime.

143. There are coverage issues which are yet to be resolved between the insurers of the CLC's Master Policy and the insurers of SRA regulated firms. This means that when a firm transfers from the SRA to the CLC (and vice versa), it has to close and be treated as going into run off before it opens as a CLC (or SRA) regulated entity.

144. If there is no successor practice to an existing SRA regulated firm that wants to become an ABS, then the firm would have to provide six years' run-off cover. The requirements may therefore distort the commercial decisions of those wanting to set up ABS. For example, it may mean that it is easier to set up a brand new entity than to merge or take over an existing SRA regulated one. There will be differences in the consumer protection provisions if some of those employed by an ABS do not have to provide run-off cover for activities they have previously undertaken – but imposing such a requirement on everyone is likely to be complicated and expensive.

145. The existence of the ARP for those unable to obtain insurance on commercial terms (e.g. because of their claims history or other high risk aspects of their business) may lead to increased risk to consumers (although in some

circumstances these firms are likely to be subject to increased supervision by the SRA). It does not appear that any information is provided to consumers about who is in the ARP to enable them to make a more informed choice about the risks they face. However, this information may increase the risk of the firm actually closing if consumers decide not to use it. We welcome the fact that the SRA is undertaking a review of the ARP.

Compensation funds

146. A number of different LAs operating compensation funds with different rules for compensating consumers and for contributing to the fund may cause confusion for ABS and for consumers. If there is a requirement for a LA to have a compensation fund, this may inhibit the development of new AR/LAs because of the practicality of setting up compensation funds from scratch. However, if there is no requirement to have a compensation fund, ABS would provide less consumer protection in some cases than non-ABS firms and may consequently have lower costs.

147. The ability for payments to be made from the compensation fund in the event of dishonesty may be a perverse incentive for a lawyer to act dishonestly since they may think that their client would be compensated in any event. It also means that honest lawyers pay for the dishonesty of others. However this is no different from, for example, all those paying motor insurance paying for claims against uninsured drivers, which adds around 4% to the cost of a motor insurance policy.

148. We also consider it appropriate to review that there are appropriate arrangements in place to ensure compensation funds are used in the interest of consumer protection.

Possible solutions

149. We will establish a Task Force with the SRA, Law Society and other interested parties to take forward work on the issues we have identified in the development of this chapter, reporting to the LSB by February 2010 on the issues that are on the critical path for ABS and for the remaining issues by May 2010. The rest of this chapter puts forward some possible options for consideration.

Minimum level of PII

150. For ABS, one option would be not to set a minimum requirement for PII. There would be a requirement on an ABS to demonstrate to the LA that it has sufficient PII for the risks it faces and the activities is carries out. Another option is to base minimum requirements on the activity being carried out by the ABS and for this to be consistent across all LAs - eg probate requires £xm, conveyancing requires £ym, family requires £zm etc. Another option would be to base the requirement on an average value of transactions during

a year (where you would expect, say, the cover for a firm doing 10,000 x £10,000 transactions to be less than a firm doing 10 x £10m transactions). Other options would be for the minimum level to be based on the number of fee earners, or the turnover of the ABS for licensed activities.

Compensation funds

151. We have also considered whether there might be another way to fund compensation funds. For example, in Australia the interest on client accounts is used in part to fund their Fidelity Fund. An alternative would be for ABS (and possibly non-ABS firms) to put a certain amount of money in trust to cover fraud claims. Although that may tie up a lot of money, so do the current arrangements.

152. It may be possible to develop a single compensation fund paid for from the ABS licence fee. However, we do not have information about the likely cost of this. There would also be a question about who would administer it. In addition, there may not be much in the fund at the start of ABS, although this may not matter in practice since it is unlikely that there would be many claims against it for some time. There is, however, a theoretical short-term liquidity risk.

153. It may be that there are alternative ways of providing an appropriate level of consumer protection. Bonds and Letters of Credit might be one alternative. However this ties up a lot of money and so may not be appropriate. There is a requirement in other professions to provide Fidelity Guarantee Insurance which it may be appropriate to introduce as a requirement for ABS.

Consumer information

154. We have considered whether better consumer information about PII could help resolve some or all of these issues. It appears that the current regulatory requirements are a substitute for consumer information and education about the possible risks that they face when using a lawyer. These risks are not specific to ABS but exist now in consumers' interactions with lawyers.

155. ABS present an opportunity to enable consumers to make more informed choices about the level of risk they are willing to take, but without undermining the confidence that they have in the legal profession generally.

156. Whether or not the current requirements change, we consider that consumers should be made more aware of the possible risks that can arise, the protection that is available and the circumstances in which they may be left without any recourse. However, such a move in itself, although desirable for many reasons, does not remove the need for more robust consumer protection arrangements to be in place to cope with extreme cases: informed

consumers may help to minimise risk, but the burden of the risk cannot be transferred to them.

Question 3

Do you have views on how indemnity and compensation may work for ABS?

a. How should an appropriate level of PII be set for ABS that are carrying out a variety of different activities, not all of which are currently regulated by the ARs?

b. Should there be minimum PII levels, which are the same for all LAs for different types of activity?

c. Are Master policy arrangements appropriate for ABS?

d. What would be appropriate arrangements for run off and successor practices to enable sufficient commercial freedom for ABS as well as protection for consumers after practice closure?

e. What should the requirements be for compensation funds in ABS?

f. How could a compensation fund work in an ABS environment, in particular when the services offered by the ABS may be much wider than legal advice and where an AR may not currently have a compensation fund?

Reserved and unreserved legal activities

Desired outcomes

- ABS provide the same levels of consumer protection for reserved and unreserved legal activities as in the current market.
- Regulatory requirements allow different forms of commercial arrangements for business structures, outsourcing, etc unless the particular circumstances of the case suggest that there is an objective justification based on evidence that it will result in significant consumer detriment.

Key proposals

157. Next year we will consider in more depth the issue of whether unreserved legal advice should be regulated. In the meantime it may be appropriate to retain the current approach to regulating non-reserved activities in non-ABS firms.

Summary of views from Discussion Paper

158. The SRA was concerned that an ABS could provide the reserved part of its service through a regulated body whilst clients received the unreserved part of the service through a separate and unregulated business. It considers that there are significant problems in terms of 'regulatory reach', clarity for customers, and the 'level playing field' that might arise from treating reserved and unreserved legal activities differently.

159. The SRA also considered that ABS should be under a duty to ensure that unreserved legal activities are regulated in a similar way to reserved legal activities. The BSB says that it shares the SRA's concerns on this.

160. It was noted by the SRA that many solicitors could offer unreserved legal activities through alternative entities. These will not then be regulated and this would be to the detriment of the consumer. This was considered to be an important issue by some respondents, because consumers may not distinguish between the services they are receiving. Consumers should not face additional risks to those that they face now.

161. The Law Society felt that ABS should be prohibited from setting up separate unregulated firms to carry out unreserved legal work. The Law Society believes there is scope for widening what is considered to be reserved legal work and for providing greater consumer protection.

Discussion

162. In some contexts a legal activity may be regulated and in other contexts that same legal activity may not be regulated. This is a result more of historical accident than design. Annex C sets out this issue in diagrammatic form.

163. In practice, the interface of reserved and unreserved legal activities has a significant impact for consumers. The scope of reserved legal activities is relatively narrow and much consumer interaction with lawyers involves unreserved legal activities (e.g. the drafting of many contracts is an 'unreserved legal activity'). Consumers are therefore heavily dependent on the type of lawyer they go to, when seeking regulatory protection. All legal advice provided by a solicitor or a solicitor's practice, whether it constitutes a reserved legal activity or an unreserved legal activity, is regulated by the SRA. However, the same legal advice, provided by someone who is not regulated by the SRA, may not be regulated at all (for example, will writing).

164. It is unlikely that consumers make any distinction between reserved and unreserved legal activities – or more broadly between regulated and unregulated legal activities. Consumers are therefore likely to assume that, to the extent they are aware of any protection afforded by 'regulation', all the advice they receive is subject to the same degree of protection.

165. In addition, the SRA extends this principle through its separate business rule so that a solicitor's firm cannot set up a separate business which undertakes legal activities which then escape the SRA's regulatory net.

166. The terms of an ABS licence can contain conditions as to the unreserved legal activities that an ABS may or may not undertake. The LSB plans to review the issue of reserved and unreserved legal activities during 2010-2011 to assess the extent to which it is necessary to redefine them. However, any changes are likely to require primary legislation and so are unlikely to be implemented before mid-2011. In the meantime, we have considered how to provide appropriate levels of consumer protection within ABS without unduly extending the scope of regulation or unduly restricting the commercial freedom of an ABS.

Regulating associated businesses

167. We want to avoid a situation where a provider of legal services could escape regulation by creating two businesses - one an ABS which only provides reserved legal activities and one which only provides unreserved legal activities (and which, perhaps, has the primary role in interacting with the consumer).

168. If an ABS has an associated business (either part of the same group or a third party) in which non-authorised people undertake unreserved legal activities, the unreserved legal activities carried out on behalf of that entity could be regulated if it provides advice direct to the consumer or if the consumer might assume that they are regulated (perhaps because they use the same brand as the ABS). This would ensure that all consumer-facing advice is regulated but would potentially bring in to regulation some activities that are not

currently regulated. This might lead to increased compliance costs, although we anticipate that ABS will want to protect their brand value and will therefore have processes in place to ensure that all advice is of a high standard. However, this approach may have adverse unintended consequences in that it may be a disincentive for providers who currently only provide unreserved legal activities to increase their consumer offerings to include reserved activities and become an ABS.

169. An alternative might be to require the ABS to ensure that all unreserved legal activities provided by unregulated associate businesses are provided to the same standard as its reserved legal activities. However the LA would only be able to take enforcement action against the licensee.

170. For the avoidance of doubt, we do not consider that it is appropriate for licensing rules to extend to the provision of non-legal activities in an associated business (for example, the provision of administrative support services or IT). Nor do we consider it appropriate to prevent outsourcing arrangements where the legal services provider subject to regulation had final responsibility for providing the relevant legal advice or carrying out the relevant legal activity.

Better consumer information

171. We believe that there is a need to collect better evidence on how well consumers understand the current situation and whether any actual or potential detriment arises from any confusion. We will make proposals for work on this issue in our 2010-11 Business Plan, in relation to both ABS and the wider marketplace. But we consider that ABS must provide the same level of consumer protection for reserved and unreserved legal activities as in the current market. In addition, we consider that a minimum requirement is transparency for consumers. They should be free to purchase any legal service, including an unregulated legal service, but they must be made aware: (i) that the legal service being purchased is unregulated; and (ii) what protections a LA provides in these circumstances. We therefore expect LAs to focus on educating the consumer on what is or is not subject to the protection of regulation. This can be done both directly and, where practicable, through requirements they place on ABS.

Question 4

Do you agree with our position on reserved and non-reserved legal activities?

a. Do you agree that ABS should be treated in a consistent way to non-ABS?

b. Should all legal activities undertaken by an ABS be regulated or just reserved legal services?

c. What role do you see consumer education playing?

d. How should ABS which are part of a wider group of companies be treated?

LA enforcement powers and financial penalties

Desired outcomes

- LAs' enforcement powers are targeted on areas of high risk and consumer detriment.
- Consumers are confident that their advisors are regulated appropriately.
- LAs' enforcement policies are transparent and take the Statutory Code of Practice for Regulators into account
- LAs' enforcement toolkit provides an incentive for compliance for all forms and sizes of ABS. In particular, it provides LAs with an effective deterrent that they are able to use flexibly in response to a wide variety of compliance and enforcement issues involving both individuals and entities.

Key proposals

172. That LAs should use the application process and their risk framework to identify higher risk ABS and target their monitoring and enforcement on them.

173. LAs' enforcement policies are published, transparent and take into account the Statutory Code of Practice for Regulators.

174. The maximum financial penalty that a LA can impose on an individual or entity should be unlimited, but with a requirement that the level of any penalty must be proportionate to all the circumstances of the case.

Relevant sections of LSA

175. Sections 95 – 102 set out a LA's enforcement powers and the obligation on the LSB to publish a list of disqualified people. Schedule 13 sets out the action that can be taken against owners. Schedule 14 (LA's powers of intervention) sets out in detail the requirements on handling any client money that an ABS is holding when an intervention is made.

176. Department for Business, Innovation and Skills: Code of Practice of Guidance on Regulation: http://www.berr.gov.uk/files/file53268.pdf

Summary of views from Discussion Paper

177. This issue was not raised in the Discussion Paper.

Discussion

178. The enforcement powers that the Act gives to LAs fall into three broad categories:

    - Powers against individuals and entities to investigate and enforce against breaches of licence requirements – these are discussed further in this chapter

- Specific powers (in Schedule 13) to take action against ABS owners – these are discussed in the chapter on ownership tests beginning on page 21.
- Powers and requirements (in Schedule 14) concerning handling client money following an intervention – these are prescriptive and we would expect a LA to follow them

179. The LSA 2007 also provides the LA with a range of enforcement tools that it can use to:

- remove a person where they breach a relevant duty or cause, or substantially contribute to, a significant breach of the terms of the licensed body's licence;
- impose a financial penalty on an ABS, or any of its managers or employees;
- modify the terms of a licence;
- revoke, suspend or modify the terms of a licence;
- refer an employee to another regulator; and
- intervene and take over a licensed body's practice.

180. We expect LAs to take a robust attitude towards compliance and enforcement, particularly in the early days where it is paramount to be alive to any developing risks and to respond quickly and effectively. A credible and effective compliance and enforcement policy (including transparency about all forms of enforcement action, both informal and formal) provides an incentive for those being regulated to comply with their obligations since there are serious reputational as well as financial risks for non-compliance.

181. This chapter sets out the approach that the LSB expects to see LAs adopting when encouraging compliance. It also includes a discussion about the level at which the LSB proposes to set the maximum financial penalty that a LA can impose on a licensed body.

182. In general, when enforcing against an ABS, a LA must take into account the Better Regulation principles. We consider that it is appropriate for LAs to also have regard to the Regulators' Compliance Code which aims to embed in regulators a risk-based, proportionate and targeted approach to enforcement.

183. LAs must develop a risk assessment process to enable them to concentrate resources on areas of LA activity that need them most. Ensuring that consumers are confident that their advisers are proportionately regulated is a key outcome to be sought by a LA.

184. We consider that the LA should seek to resolve issues of non-compliance informally at first (unless the non-compliance is so serious as to merit

immediate action). Such an approach will enable early resolution of a wide range of issues, some of which may be relatively minor. It may also enable resolution of more serious issues, saving resources for both the LA and the ABS, producing a satisfactory outcome more quickly for consumers and the ABS.

185. However, the LA's enforcement powers are important tools in setting the right incentives to ensure that ABS comply with the terms of a licence and the regulatory objectives more generally. The specific enforcement tools will help improve the performance of an ABS if its behaviour is inconsistent with one or more of the regulatory objectives or its licence, and informal resolution has failed or is inappropriate. The LSB views the power of directly intervening against an ABS as being a very severe sanction which may in practice be used in conjunction with the suspension or revocation of a licence. As a result, the other main tools - an ability to impose a financial penalty and an ability to disqualify a person - have to be wide in scope.

186. We expect that LAs will obtain information from a wide range of formal and informal sources to inform their enforcement decisions. In addition to formal powers, a LA will be able to gather information from a number of different sources. For example:

- admission of non-compliance by act or omission by proactive notification to the LA made by the HoLP or HoFA or another person within the licensed body (more broadly, it is expected that licensed bodies will be forthcoming with information that will be material to a LA);
- information from the LA's regulated community, other regulators and their regulated community, or other stakeholders more generally;
- outcomes from self-assessment processes that are established by the HoLP or the HoFA in order to address on-going concerns and to learn from compliance experience as the business develops;
- outcomes from inspections performed by a LA;
- issues that arise in discussion with a licensed body; and
- identification of issues through research and analysis.

187. The LA will assess the information available and form a decision about whether it requires more information to enable it to make an initial assessment about whether to proceed with any type of enforcement action (either informal or formal).

188. Once the LA considers that it has all the information it needs, it will decide whether (and if so what) action is appropriate. LAs' guidance should give examples of the circumstances in which it is likely to take action and the form of that action. This should include how it takes into account the risk that is

posed to one or more of the regulatory objectives and professional principles. In particular LAs may wish to state how they will take account of the following:

- best regulatory practice including the requirement that its activities must be proportionate, consistent and targeted only at cases in which action is needed;
- whether the act or omission has taken place over a long time or is part of a series of the same or similar actions or appears to be deliberate or vexatious or follows a failure to resolve the matter informally in a way that the LA considers satisfactory;
- the seriousness of the act or omission and the impact (or likely impact) of it on consumers and those being regulated;
- the desired outcome for consumers of taking action and whether that outcome is likely to be significantly beneficial compared to the impact of not taking action;
- the likely impact on those being regulated by the LA and the likely impact on the wider provision of legal services including public confidence in those services and in the regulatory framework;
- whether the resource requirements needed are proportionate to achieving the desired results; and
- any other matters that it appears appropriate to take into account.

Modification of licence terms

189. The Act does not specifically provide LAs with the power to give directions to an ABS (unlike the LSB which does have that power in relation to ARs). However it does give a LA the power to modify the terms of a licence in circumstances specified in its licensing rules. In general, in other regulatory regimes, modification without a licensee's consent can only be carried out in very limited circumstances such as part of enabling other legislation. In ABS, it may be that this power could be used as part of its enforcement tools when the LA wants the ABS to undertake certain actions. Such a modification could be time limited if appropriate in the particular circumstances of the case. If the ABS consents to the modification, then no issues arise. However we consider it may be appropriate for LAs to offer an indicative, but necessarily exhaustive, list of circumstances in which they might use their power to modify licence conditions without consent either as a single enforcement tool or as an emergency measure before a wider investigation which may lead to the revocation of a licence.

Referral of employees to appropriate regulator

190. A LA may refer to an appropriate regulator any matter relating to the conduct of an employee or manager of a licensed body or a HoLP or HoFA. The Framework MoU (see page 89) should facilitate this process. LAs must set

out the circumstances when they may do this and the criteria they are likely to use in doing so.

191. The Act also gives LAs the power to refer employees to the LSB. However our enforcement powers relate only to ARs and LAs; we cannot take action against individuals.

Disqualification

192. The LA may disqualify people from being a HoLP, HoFA, manager or employee of an ABS if the person breaches a relevant duty or causes a breach of the terms of the licence (intentionally or negligently). Licensing rules must make provision about the criteria to be applied and procedure to be followed by the LA in determining whether a person should be disqualified and the process for reviewing a disqualification. There must be a review procedure for disqualifications; we consider an appeal to the appropriate review body (see page 59). As with other aspects of enforcement, we expect LAs to publish their criteria and processes for using these powers.

193. The LA must notify the LSB of any determination by it that a person should be disqualified, as well as the results of any review of that determination. The Act requires the LSB to publish a list of people who have been disqualified.

Financial penalties

194. The Act gives LAs the power to impose financial penalties on individuals and entities. Penalties are paid to the Government's Consolidated Fund (i.e. the government's bank account); the LA does not keep the money paid.

195. We expect LAs' licensing rules to set out the criteria it will apply in deciding whether to impose a penalty and how it will decide the appropriate level of any penalty including a maximum. We expect the LAs to take into account the LSB's own enforcement process (once this has been finalised) and best practice by regulators generally, including the Statutory Code of Practice for Regulators.

196. Financial penalties are likely to be used when, in the LA's judgement, it is appropriate to attempt to change the behaviour of the licensed body by penalising the specific act or omission identified. If the LA is investigating a number of breaches by a licensed body as separate investigations, it may be appropriate for each investigation to impose a separate penalty, in each case of up to the maximum amount (if any). A further aim is to deter future non-compliance by the licensed body on which the penalty is imposed and by other licensed bodies. The LSB does not consider that it is essential that LAs have an internal review process to consider appeals against financial penalties before they are made to the appellate body.

197. The LSB has to set the maximum level of financial penalty that a LA can impose. A high maximum level gives a LA the flexibility to exercise its discretion and judgement in setting a penalty in a way that enables it to take into account the likely wide variation in the outcomes of investigations that it will encounter.

198. Currently the SRA can impose a fine of £2000 on a solicitor, but the Solicitors Disciplinary Tribunal ("**SDT**") can impose an unlimited fine for the more serious matters that are referred to it. The Discipline and Appeals Committee ("**DAC**") can impose a fine of up to £1,000,000 on a licensed conveyancer or CLC regulated recognised body. The CLC's Investigating Committee will shortly be able to impose a fine of up to £3000. For ABS, appeals against financial penalties can be made to the appellate body (see page 59) on grounds set out in the Act:

- the imposition of the penalty is unreasonable in all the circumstances of the case;
- the amount of the penalty is unreasonable; or
- it is unreasonable of the LA to require the penalty imposed or any portion of it to be paid by the time or times by which it was required to be paid.

The appellate body, can quash the penalty, substitute a lower amount or alter the time in which it has to be paid.

199. We consider that setting the maximum penalty for all ABS at the same level as the SRA's current maximum is too low to act as a deterrent since, unlike currently, the LA will be investigating all licence breaches, including the types of breach that can currently be referred to the SDT or DAC which have significantly greater fining powers. We have also considered whether the current maximum level of fine for criminal offences (£5000) would be appropriate but, for the same reasons, have concluded that it is not.

200. Another alternative we considered was to set the maximum that could be imposed on an entity at 10% of its turnover (reflecting the provisions in other regulatory statutes) and on an individual at a multiple of their annual salary (including bonus, pension, etc). However, there may be circumstances in which a LA considered it appropriate to impose a far greater penalty. In addition, responses to the LSB's consultation on its own powers to impose a penalty have raised opposition to introducing a concept derived from competition and utility regulation to the legal sector.

201. Therefore, consistent with our proposal for a single appellate body to hear all ABS-related appeals (and therefore with the SDT's powers to impose unlimited penalties), we consider it appropriate that the level of penalty that a LA can impose on an individual or entity should be unlimited, with a

requirement for the LA to act proportionately to the circumstances of the particular case. This is consistent with the FSA's power to impose financial penalties.

202. Details about the draft statutory instrument that the LSB proposed to make in respect of the maximum amount of a financial penalty are set out at Annex D.

Suspension and revocation of licence

203. The LA may also suspend or revoke a licence and its licensing rules must explain the circumstances in which it might take this action. The LSB considers it likely that this power will mainly be used in conjunction with a LA's powers to intervene in the running of an ABS (see page 46). However, LAs should also consider the approach they would take if an ABS asked for its licence to be revoked because it wanted to shut its business.

Intervention powers

204. The Act gives a LA powers to intervene in an ABS in certain circumstances which include breach of licence conditions, insolvency, dishonesty and the protection of clients' interests. The LSB expects a LA's licensing rules to set out how it will comply with the requirements in the Act in relation to handling money in an ABS it has intervened in and that the LA's auditors will have approved the arrangements.

205. The LA may recover costs incurred by it in taking such intervention action. The LA should be under a duty to minimise such costs and its licensing rules must explain how it will do this. These costs should be recorded in the approved regulator's annual accounts. However it may be that when an intervention occurs, the ABS has no ability to pay any significant amount of costs. In such cases, consumer protection should be paramount and LAs should not delay action for fear that costs cannot be recovered. Any irrecoverable costs would, in the view of the LSB, be appropriately charged against overall operating costs and hence recovered from the licensed community as a whole.

206. We expect LAs to publish details of all its enforcement action and to monitor trends, patterns and incidence of enforcement action to provide on-going assessment of how licensed bodies are performing and the type of risks its enforcement action has identified.

Question 5

Are the enforcement powers for LAs suitable?

a. What is your view on the proposed maximum level of financial penalty that a LA can impose on an ABS?

b. If you do not consider the proposed maximum to be appropriate what amount or formula would you propose?

c. Will LAs have sufficient enforcement powers?

d. Will ABS have sufficient clarity as to how the enforcement powers may be used?

e. In what circumstances should a LA be able to modify the terms of a licence?

f. Are there appropriate enforcement options for use against non-lawyer owners?

Access to justice

Desired outcomes

- ABS provide examples of innovative and flexible ways of providing a greater range of services and enhanced value for money for consumers.
- Consumer awareness and understanding of their right to, and how to get, legal advice improves.
- Consumer trust in the provision of legal services improves.
- ABS provide examples of improving access to justice that can be used by ARs, LAs and the LSB as examples of good practice in improving access to justice in general.

Key proposals

207. That ABS applicants must explain how they anticipate they will improve access to justice.

208. LAs must not consider the impact on access to justice solely or mainly based on requirements such as the provision of face to face services, the number of traditional firms in a given area, or categories of legal advice provided.

209. LAs must issue a progress report annually which indicates how it has and plans to promote the regulatory objectives building on the analysis of the risks to them over the previous year. That report will include a particular focus on access to justice.

Relevant sections of LSA 2007

210. Section 83 (5)(b) of the LSA2007 requires licensing rules contain provision as to how the LA, when considering the regulatory objectives in connection with an application for a licence, should take account of the regulatory objective to improve access to justice.

Summary of views from Discussion Paper

211. There was general agreement on the need to define what we mean by access to justice. A number of respondents attempted definitions. Most implied that the concept of access to justice is wider than enabling face-to-face contact and ensuring geographical proximity between consumer and provider.

212. The impact of competition on access to justice was a common theme. Some respondents felt that competition may provide opportunities to increase access to justice through innovation and flexibility in the ways that legal services are delivered. Others feared the impact of new entrants to the market would, in particular, be detrimental to smaller, traditional firms.

213. Several respondents wanted to see provisions for monitoring and measurement – either to monitor the impact of market changes or as a means

of determining the volume and type of bodies that can be licensed in a year. There were several recommendations that the LSB should commission research into access to justice.

214. There was some concern amongst special bodies that additional regulation could reduce access to justice because the regulatory burden may mean they leave the market. There was specific mention that this may impact upon vulnerable clients.

Discussion

215. The LSB does not accept the idea that ABS present a risk to access to justice that is different to those risks posed by other available structures. On the contrary, we consider this debate to have been satisfactorily closed by Sir David Clementi's report in 2004 and the passing of the Act.

216. The Act requires licensing rules to explain how, when assessing ABS licence applications, a LA will take into account the regulatory objective to improve access to justice. The LSB considers that this requirement should be used as a means of defining and developing a move to a more dynamic and consumer focused legal services market. We therefore propose that our guidance will be explicit in preventing LAs from defining access to justice as only the provision of face to face services or the number of high street firms in a given area. Furthermore, we will not allow a LA to define access to justice on the grounds of the categories of legal advice that an ABS wishes to provide. Although we believe that these indicators give one measure of the impact of changes to the market on access to justice, they need to be assessed with a wider combination of measures, especially of the outcomes for consumers, before a full view can be formed. Hence we do not accept the argument that individual licensing decisions should be made on this basis.

217. We want to avoid the issue of access to justice being used as a means of embedding or creating cross subsidies across different kinds of ABS or indeed other types of legal services provider. For example, putting aside questions of whether it would be legal to impose such restrictions, we do not agree in policy terms with the suggestion that new providers entering the market as ABS should be obliged to offer financial support to existing providers of legal services as a means of safeguarding access to justice. We consider that many of the arguments made confuse the impact of ABS with the impact of large providers. It does not seem practical or reasonable to expect a small ABS to subsidise larger traditional legal practices. Similarly we cannot justify commercial restrictions on small ABS that do not apply to their competitors that are simply structured differently. The question that remains is one of size: should larger providers face greater restriction on entering the market than small firms? It would be inappropriate to create rules against large firms since competition law already provides protection against the

abuse of a dominant position. It is therefore inappropriate to introduce new cross-subsidies into the market. We expect that efficient firms (both small and large) will be able to adapt to changes in the market brought about by ABS and respond better to the needs of consumers. Subsidising inefficient firms is not in the long term interests of consumers.

218. It is our view that ABS firms as a category should have no greater regulatory burden placed upon them than already exists for other market operators over and above the additional requirements specified in the legislation, unless a specific risk to the consumer has been identified and there is strong evidence of consumer detriment. It is not the job of a regulator to position general barriers on the basis of theoretical risks. The LSB has yet to be presented with compelling evidence to justify any such general restrictions.

219. We have also considered if ABS should be required to deliver *pro bono* work and have concluded that, in the absence of a similar requirement in the rest of the market, they should not. Including an explicit requirement for ABS to conduct *pro bono* work may act as a barrier to entry for new legal services providers coming into the market. We believe that legal services providers, be they firms of solicitors, barristers chambers or any other kind of organisation, should be free to use *pro bono*, whether as a marketing tool or as part of its wider corporate social responsibility commitments. Making it compulsory means that this advantage would be lost. There is also a significant risk that such a requirement could not be enforced in practice. For example, it would be difficult and arbitrary to determine what kind of requirement was proportionate to the size of the firm and whether it would be required of all ABS.

220. There has been a suggestion that there could be a legislative change to ensure that the interest earned on client money held by an ABS could be used to fund charity legal services as a means of satisfying the access to justice condition. In practice this would mean that when a client is being charged on an hourly rate and they have paid money in advance, some or all of the interest earned on the money in the client account would be used for this purpose. Again, we see no argument for this kind of approach to ABS in the absence of a more general requirement. There is a danger that this could be seen as an indirect tax on consumers. It would also be very difficult to regulate proportionately. It is difficult to imagine this being universally popular with consumers but we do not discount this as a way of legal service providers living up to their corporate social responsibility agenda. For example, in a liberalising market we would expect providers of legal services to compete in a range of imaginative ways including corporate social responsibility. Thus we believe that it is not consistent with our overall approach to regulation to direct action in this area. However we do not see

that an absence of a positive regulatory requirement in this area in any way diminishes the legal profession's tradition of supporting *pro bono* directly and indirectly.

221. Another issue raised during the debate has been the argument that ABS will impact negatively on access to justice because ABS will choose to target their efforts in particularly profitable areas of the market. We do not consider this issue to be unique to ABS. All efficient law firms will make decisions as to what type of work, clients and location is likely to maximise their income. There are many examples even within the current regulatory framework, of firms choosing to provide services in just one category of law, perhaps because they perceive a competitive advantage in specialisation. Undoubtedly this may have an impact on their competitors but we do not propose to artificially limit such competition. It may be that increasing competition in the provision of legal services leads to changes in the type of work that some firms undertake, and/or that some types of advice are provided in a wider variety of ways than currently. We believe that legal services providers should be free to innovate and develop new ways of working to meet consumer needs and demands, whatever their chosen business model. We therefore agree with Sir David Clementi that it is not appropriate for regulation to seek to restrict this.

Measuring the impact

222. Many respondents to our discussion paper said that it was important for the LSB to measure the impact of competition both in terms of innovation and impact on traditional legal services providers as a means of assessing its impact on improving access to justice. We expect LAs to measure the performance of the market in a way that will help to identify the impact of changes in the market on access to justice. Over time, we expect this to lead to more informed regulation. We further propose that LAs must issue a progress report annually which indicates how it has and plans to promote the regulatory objectives building on the analysis of the risks to them over the previous year. That report will include a particular focus on access to justice.

223. There might be some benefit for those LAs that are regulating similar activities to have a consistent approach to understanding the market from a consumer perspective. For example, LAs may choose to facilitate the central collection and coordination of information as means of developing a shared approach on access to justice. We expect to work with LAs and ARs to define the scope and content of monitoring activities.

Question 6

What do you think of our approach to access to justice?

a. Do you think the wide definition to access to justice that we have taken is appropriate?

b. Is asking an ABS on application how they anticipate that they will improve access to justice a suitable approach?

c. Do you agree that restrictions on specific types of commercial activity should not be put in place unless there is clear strong evidence of that commercial practice causing significant harm?

d. Do you agree that LAs should consider how ABS in general impact access to justice rather than trying to estimate the impact of each application singularly?

e. Do you agree that LAs should monitor access to justice?

Appellate bodies

Desired outcomes

- At the start of ABS, a single appellate body to hear all ABS-related appeals.
- The appellate body's costs and processes are transparent, efficient, fair and public.
- The appellate body has sufficient resources and expertise to deal with complex issues.

Key proposals

224. There should be a single appellate body to hear all ABS-related appeals, including those concerning disciplinary matters such as the removal of the HoLP or HoFA's designation. We encourage active consideration as to whether this should become a single appellate body for all non-ABS matters as well.

225. Discussions should continue with the General Regulatory Chamber ("**GRC**") about whether it would be an appropriate body to fulfil this role, the timescale for adding ABS appeals to its existing functions and the likely cost of different types of appeal.

226. The LSB's initial view is that the relevant costs of the appellate body should, in principle, be funded from the ABS licence fee. However, this will need to be explored in more detail as the likely costs become clear.

Relevant sections of LSA

227. Sections 80 and 81 set out the functions of the appellate body and the process for recommending what the appellate body should be.

Summary of views from Discussion Paper

228. This issue was not raised in the Discussion Paper.

Discussion

229. A body (or bodies) is needed to hear and determine appeals from decisions made by a LA. This body can be either a) a new body established by order or b) result from a change in functions of the SDT or the DAC established by the CLC.

230. The function of an appellate body (or bodies) would be to hear appeals about decisions i.e. the application of the licensing rules made by a LA and appeals against financial penalties imposed. It is a general principal of natural justice that whenever decisions are made by a body there must be a way of appealing against the decisions. This will be the case for all LAs and potential LAs. This includes the LSB if there is no competent LA to license an ABS.

231. We would expect that every licensing authority would have a comprehensive and quick internal review system to consider representations against a decision to refuse a licence application and the terms of a licence. Such a review should be conducted by a person or people who have not been involved in considering the application itself. The process must be set out in the LA's licensing rules and it is for the LA to consider how far the process should involve a review of the legal adequacy of the process undertaken or should constitute a re-assessment of the application. The appellate body would only hear appeals from those who have exhausted their options for internal resolution by the LA, or when the LA has failed to complete a review within its own timescales.

The Solicitors' Disciplinary Tribunal and the CLC's Discipline and Appeals Committee

232. As discussed in previous chapters the regulation of legal service providers has been through the rules of the profession, where issues arising in the organisation they managed were considered to be breaches in the code of conduct and the duties that the individuals owed. As the legislation makes particular reference to the SDT and DAC this analysis will focus on them.

233. For the SRA disciplinary appeals are heard by the SDT which hears appeals on matters relating to the discipline of solicitors and some internal processes. The SDT has a legally qualified chairman, lay and solicitor members. It is adversarial in nature and operates on a criminal standard of proof. The costs of the tribunal are paid by a levy on the whole profession recovered through the practicing certificate, with the LSB approving the level of budget. It handles about 200 cases per year; however, there is a backlog of cases at the SDT. One constraint that has recently been removed is the prohibition on paying solicitor members of the tribunal. The cases heard by the tribunal are technical and increasingly complex.

234. DAC hears about 10 cases a year relating to dishonestly and breaches of the CLC's rules. The DAC sits as a panel comprising a legally qualified chair, a lay member and a licensed conveyancer, assisted by a legal adviser. The administration costs are paid by the CLC. Respondents are sometimes not legally represented.

235. The SRA told us that as part of the move to firm based regulation they have considered "cold cases" where judgements have been made by their internal processes under the current arrangements were reconsidered in light of the new entity obligations. In every one of the twenty cases they considered they determined that the entity has some share of the responsibility. In some cases the entity would have been held entirely accountable and in others the individual was deemed to have been responsible but there was still an element of responsibility for the entity.

General Regulatory Chamber ("**GRC**")

236. In other areas of regulation there has been a trend following the Review of Tribunals by Sir Andrew Leggatt to consolidate tribunal functions. The Tribunal Service now operates a unified tribunal which consists of first tier chambers and an upper tribunal which, predominately, hears appeals from the first tier tribunal. One of the chambers in the first tier tribunal is the GRC which was established on 1 September 2009. The GRC brings together a range of previously separate tribunals that hear appeals on regulatory issues.

237. Currently the following tribunals are included in the Chamber:

- Charity (appeals against the Charity Commission);
- Consumer Credit (decisions of the OFT and anti-Money Laundering provisions);
- Estate Agents (prohibited persons appeals and appeals against warnings); and
- Transport (Driving instructors, London service permits and some postal carrier disputes).

238. In January 2010 further tribunals will join the GRC:

- Information (appeals against decisions of the Information Commissioner);
- Gambling Appeals (appeals against decisions of the Gambling Commission);
- Claims Management Services;
- Immigration Services;
- Adjudication Panel for England; and
- when the relevant provisions are commenced appeals under the Regulatory Enforcement and Sanctions Act 2008 (RES Act)

Options for the appellate function

239. Two decisions need to be made about the appellate function. The first is about the scope and function of the body and the second is about the form and location of the body. The four options considered about scope and function are:

- each LA has its own separate appeals body (e.g. SDT and DAC);
- create (or nominate) a single body to hear licensing application appeals only (not conduct or rule transgressions);
- create (or nominate) a single body to hear all ABS related appeals; and
- create (or nominate) a single body to hear all legal service appeals.

240. The LSB has considered these options against the following criteria:

- consistency between ABS and non-ABS decisions;

- consistency with decisions about the individuals involved;
- consistency of decisions about different LAs' application of the rules;
- establishment costs;
- running costs;
- appropriateness for appeals against LSB if direct licensor;
- fit with current systems and knowledge;
- ability to attract and train high quality members;
- consistent and widely used rules and processes; and
- scope of change to current arrangements.

241. Our assessment of the options is set out in the matrix on the following page:

	Each licensing has its own separate appeals body	A single body to hear licensing application appeals only	A single body to hear all ABS related appeals	A single body to hear all legal service appeals
Consistency between ABS and non-ABS decisions	High (only for similar business)	Low	Low	High
Consistency with decisions about the individuals involved	High (for those where the approved persons are regulated by the LA)	Low	High	High
Consistency of decisions about different LAs application of the rules	Low	High	High	High
Establishment costs	Low	High	High	Very high
Running costs	High	Low	Low	Medium
Appropriateness for appeals against LSB if direct licensor	Low	High	High	High
Builds on current systems and knowledge	High	Low	Low	Medium
Ability to attract and train high quality members	Low	High	High	High
Consistent and widely used rules and processes	Low	High	High	High
Scope of change to current arrangements	Low	Low (as are new functions)	Medium	High

242. The LSB considers that a single appellate body for all ABS-related appeals would:

a. provide clarity for ABS and potential ABS about the process for any appeals and would build up a body of expertise over time on licensing and other matters; and

b. enable economies of scale to be obtained in terms of administrative and appellate functions.

243. On balance our preferred position is a single unified body to hear all legal service appeals. However, this may present too large a change prior to the implementation of the ABS regime and would require more thorough investigation. As an intermediate position we propose that a single appellate body is established to hear ABS related appeals on decisions made by LAs.

244. We have considered whether it would be appropriate for the existing appeal bodies to consider appeals where issues are raised that are common between ABS and the rest of the market and for the new appellate body to consider only appeals that are ABS-specific. However, that approach has the potential to cause confusion about what matters would be dealt with by each body and introduces the need for additional processes to decide which body should hear a particular type of appeal. This is likely to increase costs and delay appeals.

Form of a new appeals body

245. We have considered the possibility of adding this function to the wider functions of the GRC who have agreed, subject to considering technical issues and to conclusions emerging from this consultation exercise, that there is no reason in principle for it not to undertake this function. We will be therefore continue discussions with the GRC on what the roles, functions and scope such a new jurisdiction might entail.

Question 7

What is your view of our preference for a single appeals body?

a. Should, in the future, a single body hear all legal services appeals?

b. If you do not think there should be a single body, who should hear appeals from LSB decisions should it become a LA?

c. Is the GRC an appropriate body to hear appeals?

d. What other options for the location of the body?

Special bodies

Desired outcomes

- Consumer protection and redress for those using special bodies for legal advice is equivalent to those using mainstream ABS.
- LAs adapt regulation and enforcement of ABS to appropriate levels, based on evidence of risk.

Key proposals

246. We do not expect to specify that ARs' initial applications to become LAs must include consideration of how they might regulate special bodies. We propose that further work is done on this issue in conjunction with potential LAs, special bodies themselves and representative bodies which will then inform our decision about how the transitional arrangements should be lifted.

247. Transitional arrangements should be removed as soon as reasonably practicable, probably 12 months after mainstream ABS starts.

Relevant sections of LSA 2007

248. Section 105 – 108 make provision for special bodies.

Summary of views from Discussion Paper

249. One regulator believes that a LA should have the ability to choose to regulate only low risk bodies, and set its licensing rules accordingly.

250. Some respondents pointed to the possible danger or temptation for special bodies' legal advisers to stray beyond areas of particular expertise. On the other hand some others thought that this may be no less likely than with, say, a general legal practitioner.

251. Some respondents, including regulators, commented that the risks are similar but not the same and regulation needs to be proportionate and based on risk.

252. Others noted that whilst special bodies have a key role in access to justice, they should not get an unfair advantage from the regulatory regime. If they give legal advice they should be subject to the same rules. Consumers must understand the level of advice they are getting, the qualification of the person giving it and their route to redress if necessary.

253. It was thought that regulators will need to be transparent about how they have reached a decision to license in each case to ensure the process is not perceived to be arbitrary or unfair. Many not-for profit bodies do have trading arms and some may therefore be motivated by income generation concerns.

254. Some believed that there was less risk that clients would be exploited, but that the impact of something going wrong could be more severe because of the vulnerability of the individuals concerned.

255. A number of respondents pointed to the important role of special bodies (particularly not-for-profit bodies) in increasing access to justice by helping some of the most vulnerable people in society gain access to the legal services they need. Consideration was also given to the wider role that these organisations play in civil society, such as through volunteering and engaging with local communities. While many respondents recognised the role of special bodies in access to justice, it was felt that these organisations should not get an unfair advantage from the regulatory regime, nor their clients an unfair disadvantage.

256. There was a general consensus that the risks to consumers from using legal services provided by non-commercial bodies are low. This is attributed to a number of factors. Some respondents felt that the absence of a profit motive or commercial imperative provided some protection to consumers. Similarly, the altruistic motivations of solicitors and others employed by or managing these types of special bodies were felt to provide further protection.

257. On the other hand, a number of potential risks to consumers who access legal services from special bodies were identified. References were made to the potential for weak or unstable governance in not-for-profit organisations, linked to problems such as poor financial management, lack of direction and limited understanding and effective management of conflicts of interest. Several respondents felt that entity regulation was needed to address these kinds of issues.

Discussion

258. The Act makes special provision for the regulation of certain types of legal service providers called ‘special bodies’. These include law centres, citizens’ advice bureaux, other advice agencies and independent trade unions providing legal services to consumers. Without the transitional protection provisions in the Act, these bodies (with the exception of independent trade unions that are permitted to offer certain services to their members without ever needing a licence) would need to have an ABS licence as soon as the relevant provisions in the Act come in to force.

259. The most important thing for us when considering our approach to the licensing of special bodies is to ensure that consumers have appropriate protections, whatever type of legal service provider they use. Where there may be issues with the quality of legal services provided, unsupervised caseworkers are currently outside of the jurisdiction of the SRA and the Legal Complaints Service (which can only investigate complaints that relate directly

to work carried out by a solicitor). There is a risk that in the absence of complaints-handling processes, consumers may have limited access to sufficient redress when something goes wrong and once the OLC is established, complaints about special bodies will continue to be outside its jurisdiction unless they are licensed. This is inherently unsatisfactory. One way to deal with this would be for the OLC to make voluntary arrangements with special bodies. This could be done in any event but it might be more appropriate to do so if transitional arrangements look as though they will take longer than anticipated to remove.

260. There are a number of issues to be considered that were raised in the consultation. These include the need for regulation to be proportionate with the level of risk to consumers and the evidence of consumer detriment; the role of special bodies in access to justice and the potential impact of burdensome regulation; the cost of regulation and finally, the matter of who will regulate these kinds of ABS. There is a degree of concern amongst those bodies representing not-for-profit organisations, that ABS regulation is not designed for these kinds of organisations. Some not-for-profit representative bodies are concerned about being categorised as ABS and regulated within the same framework as commercial new entrants.

261. However, on balance we consider the intention of the Act, the importance of creating a level playing field in legal services regulation, and the need for consumer protection to be key in our decision to end the transitional arrangements. Based on the information we have received, we consider the risks associated with special bodies to be relatively low and that, balanced against the need for special bodies to assess what they need to do to comply with ABS requirements, it is unlikely that significant consumer detriment will be caused by waiting a year after the mainstream ABS regime is introduced to implement ABS requirements for special bodies. Successful implementation will need both the LSB and the approved regulators to engage carefully with special bodies about how we introduce regulation.

262. All special bodies will be required to meet a core set of minimum requirements. It will be the discretion of the LA to decide the extent to which these requirements are to be applied to each special body, based on an assessment of risk using all of the information available. It is possible for the requirements to be very low, if the risk to consumers is evidenced to be such, but they may also be higher.

263. The special bodies regime set out in the LSA 2007 also allows for a LA to respond to a request by a special body to modify some of its rules in relation to that special body or for the ownership requirements not to apply. In practice, if a special body considers itself to be low risk and makes an application for the licensing rules to be amended accordingly, the LA can

make the necessary modifications. If a special body makes an application for modifications to the licensing rules, the LA may also choose to make amendments which place additional requirements on the body if a particular risk has been identified.

264. We expect that the supervision would be proportionate for all entities but LAs will need to consider the impact of their supervisory approach particularly for special bodies and may wish to have a specialist approach that will support the transition into regulation.

Question 8

Do you agree with our approach to special bodies?

a. Do you think that special bodies' transitional arrangements should come to an end?

b. Do you think 12 months after the start of mainstream ABS is sufficient time for them to gain a full licence?

c. Do you think LAs should adapt their regulation for each special body?

d. Do you agree there are some core requirements that all special bodies should meet? If so, what do you think these are?

e. What are your views on the suggestion that the OLC should make voluntary arrangements with special bodies?

Head of Legal Practice (HoLP) and Head of Finance and Administration (HoFA)

Desired outcomes

- High quality HoLPs and HoFAs from a wide range of backgrounds and diversity.
- Strong governance arrangements to:
- provide HoLP and HoFA with access to CEO, Board, non-executives, LA whenever necessary;
- ensure compliance with LSA and licence requirements;
- ensure appropriate operating procedures;
- provide a mechanism for ABS staff to raise concerns which are acted upon appropriately.
- Commercial decisions (i.e. not the regulator's) form the basis of tests for competence of HoLP and HoFA.
- ABS compliance with licence requirements is high, with minimum enforcement required by LAs.

Key proposals

265. The fitness test be the same as that for ABS owners, and apply to all HoLPs and HoFAs, whatever their qualifications.

266. There is no need to undergo the fitness test every year but there must be a requirement to notify the LA in the event of a change in status of a HoLP or HoFA.

Relevant sections of LSA 2007

267. Sections 91 and 92, and paragraphs 11-14 of Schedule 11 to the Act set out the roles of the HoLP and HoFA.

Summary of views from Discussion Paper

268. Where commented on, most respondents thought that the test for the HoLP and HoFA should be proportionate so as not to create unnecessary barriers to entry for ABS. Respondents considered the roles of the HoLP and HoFA to be important with the emphasis being upon their having appropriate qualifications and experience.

Discussion

Background

269. The Act specifies that the HoLP must take reasonable steps to ensure compliance with the terms of the licence and that the HoFA has similar responsibilities for ensuring compliance with accounts rules. They both have statutory responsibilities to report any breach of the licensing rules to the LA.

The HoLP must consent to their designation and must be an authorised person in relation to one or more of the licensed activities. The HoFA must consent to their designation. The LA may approve a person's designation only if it is satisfied that the person is a fit and proper person to carry out the duties imposed by the Act.

270. Licensing rules may make provision about the procedures and criteria to be applied when determining who is a fit and proper person to be a HoLP and a HoFA, for review of such determinations, for withdrawal of such approval (and for review of such withdrawal) and for the procedure to be applied when an ABS ceases to have a HoLP or HoFA.

271. These two functions are therefore very important in ensuring that lawyers' compliance with their professional principles is not compromised and that consumers are properly protected and receive good quality legal advice. The LSB considers that it is a commercial decision for the ABS to decide what its overarching compliance policies should be and the best way to ensure a culture that promotes ethical practice and compliance with licensing rules. It may be that the representative sections of the ARs see a role in providing advice about what is appropriate. However, we consider that it is appropriate for a LA to set requirements for determining whether the HoLP and HoFA are fit and proper.

Guidance

Governance

272. In order to encourage a culture of compliance, the LSB anticipates that LAs will want to give guidance on the appropriate level of seniority for a HoLP or HoFA and who they report to, taking into account the size of the ABS. We would consider it appropriate to have a requirement for the HoLP/HoFA to report to the most senior level of management (in a corporate ABS, the board of directors/members), if they are not themselves a member of the most senior level of management. However, they must have the freedom to dissent from collective responsibility when reporting on matters to the LA. In either case, we would expect there to be a requirement for their roles and responsibilities within a firm to be clearly defined, although not necessarily by reference to a single regulatory model.

273. In addition, LAs should set principles for how their expectations of:

a. good governance and operating procedures to ensure compliance with licence conditions; and

b. identification by the ABS of risks, in particular to consumers, of its activities.

Fit and proper test

274. The LSB considers that it is appropriate for the fit and proper test for the HoLP and HoFA to be the same as its proposed test for external owners:

- any criminal convictions or cases pending in the UK or elsewhere;
- any previous disciplinary action taken by a professional body in the UK or elsewhere, whether concluded or not;
- whether the owner has ever been disqualified as a director; and
- any other material information that might have a bearing on their fitness to be a HoLP or a HoFA in the ABS.

275. The test must apply to authorised and non-authorised persons alike. The LSB does not consider it appropriate for a HoLP or HoFA in an ABS to have a lesser test than an owner of an ABS. However, it may be that in a LA's judgement, even if the outcome of the test is the same, it may be acceptable for a person to be an owner of an ABS but not to be a HoLP/HoFA. The LA should include in its rules the criteria it will use to differentiate between these roles.

276. We do not consider that it is proportionate for there to be a requirement for these tests to be renewed on an annual basis. That is likely to lead to a significant regulatory burden with little prospect of significant identification of people in the roles who are not fit and proper. We anticipate that for good commercial reasons, ABS will ensure that strong governance (including identification and management of conflicts of interest) will provide the means by which potential problems with the fitness of the HoLP or HoFA are identified, dealt with and the outcome notified to the LA. We also expect ongoing risk assessment by the LA to identify those ABS where enforcement action should be targeted.

277. We consider that the qualifications and experience of the HoLP and HoFA are, similarly, matters for the ABS to decide, based on the requirements of its business and the expectations of its staff. Unless they are demonstrably inappropriate for fulfil their role, the information about the HoLP/HoFA's qualifications and experience should be used by the LA to inform their risk assessment of the ABS in order to target their monitoring and enforcement proportionately. It may, however, be appropriate to have a requirement for targeted professional training for one or both of these roles, although we consider that the case for any such requirement is likely to be stronger for the HoLP. We expect LAs' licensing rules to provide guidance on these issues, including the way in which they will approach their risk assessment.

278. Where an applicant fails the test to become a HoLP or HoFA, the LSB proposes that the same review process should apply as for the fitness to own test (ie recourse to the same appellate body). However, a LA should not use

the decision against an individual nominated for the role as a reason to deny a licence subsequently if a more satisfactory individual is identified.

One person for both roles?

279. The question as to whether one person can be both a HoLP and a HoFA is particularly relevant for smaller ABS. Where there is no separation of ownership and management, more reliance is placed on the fitness to own test to ensure that the HoLP or HoFA fulfils their role. We consider that in many instances it will be appropriate for this role to be filled by the same person and that this is a matter for the ABS to decide.

Ceasing to have a HoLP or HoFA

280. The Act requires that an ABS has a HoLP and a HoFA at all times (although these can be the same person). If a HoLP or HoFA is suspended from work or is dismissed from employment, we propose that the managers of the licensed body will collectively be responsible for informing the LA of this fact, and that this should form a condition of the licence. A licence could also specify the maximum time for which such an arrangement could be in place. After notification has been made, it may then be possible for the LA to deal with the problem (for example, by approving another individual emergency status as a HoLP or HoFA).

Question 9

Do you think that our approach to HoLP and HoFA is suitable?

a. Do you think that our approach on focussing on compliance systems across the organisation is suitable?

b. Do you think that HoLP and HoFA should undergo a fit and proper test?

c. Should there be training requirements for the HoLP and HoFA?

d. Do you agree that the HoLP and HoFA could be the same individual (especially in small ABS)?

Complaint handling for ABS

Desired outcomes

- Consumers of legal services provided by ABS must be afforded the same protections as consumers from non-ABS providers.
- Referral of complaints to other bodies is done in a way that minimises inconvenience for consumers.

Key proposals

281. Regulation should not seek to introduce a “one size fits all” approach to resolving complaints.

282. ABS must ensure their complaints systems deal with all aspects of a complaint, not just those against lawyers.

283. If the LSB issues guidance on handling first-tier complaints to non-ABS, ABS should follow them.

284. If OLC has no jurisdiction to investigate a complaint and there is another body that can, OLC will refer the complaint to the appropriate body.

Relevant sections of LSA 2007

285. Section 83 (5) (g) requires licensing rules to contain the provision required by Sections 112 and 145 (requirements imposed in relation to the handling of complaints).

Summary of views from Discussion Paper

286. There was general agreement that complaints handling in relation to legal services provided by ABS should be regulated in the same way as for non-ABS firms.

287. On the issue of misconduct, the preference of respondents was for conduct issues to be handled by the appropriate professional regulator.

288. There were comments on the need to consider how the system would work if and when complaints relate to different professionals, for example within a multi-disciplinary ABS.

Discussion

289. Managing complaints is an important part of consumer protection and will form part of the regulatory arrangements required for the licensing rules for ABS. One of the main drivers for the changes to the regulatory framework, and the LSA 2007, was the need for better complaints handling in the legal sector. It is in this context the complaints requirements for ABS must be considered. The variation of possible business structures allowed under ABS makes it vital to consider the circumstances in which services are provided

and the rights of consumers to complain about the service they receive. The scope of a complaints system will vary depending on the business model, but the primary focus should always be the consumer.

First Tier Complaints

290. The LSA 2007 says that in general, complainants must first use the firm's own complaints procedure (the "first tier complaints" process) before their complaint can be considered by the OLC. The Act requires ARs to require those they regulate to establish and maintain complaint handling procedures. In the first ABS discussion paper, we asked the question 'How should complaints-handling in relation to legal services provided by ABS be regulated?' There was a general consensus amongst respondents that provisions for complaints handling should be the same for ABS as for non-ABS firms. We agree with this view and believe that it would be wrong for consumers to be afforded different regulatory protection by the mere fact that they are advised by a person working in one business model as opposed to another.

291. Respondents supported our view that arrangements will need to be robust enough to take account of complaints made about different services that may operate under different regulatory disciplinary regimes. This is particularly pertinent in ABS but is to some extent already an issue with the current arrangements where complaints processes about different kinds of lawyers working together may differ.

292. The importance of consumer focused information, so that people know how and where to complain, is also a priority identified by the respondents. ABS will potentially have more complex accountability issues to address, but this complexity should not be passed on to the consumer through a complaints process which is difficult to navigate. The process for complaints handling should be clear and consistent to enable consumers to use it.

293. The Act gives the LSB discretionary powers to make binding rules about what complaint procedures must include. The LSB will be working with the OLC and ARs to improve the way in which complaints are currently considered by law firms. We would expect any guidance given by ARs to existing law firms and ABS to be the same. Similarly, if the LSB decides to use its powers to set requirements for rules for first tier complaints for approved regulators, we expect that they will apply to ABS in the same way as for all other legal services providers.

Guidance

294. We recognise that any guidance (or LSB rules) must take into account the need to ensure that the potential complexities of complaints handling for multidisciplinary practices does not have an adverse effect on the

complainant. They must also take into account that there may be many different ways of dealing with complaints, and provide flexibility for a law firm or ABS to adapt how it deals with complaints to the needs of consumers. Some ABS will have sophisticated complaint management systems and a trusted brand which already offer a range of services to their customers. It is our view that the regulatory requirements should build on the best practice and, so long as the consumer's right to complain is protected, not undermine existing systems or create unnecessary requirements.

295. We expect LAs' guidance to include but not necessarily be limited to the following:

- the need to ensure that complaints are dealt with fairly, promptly, constructively and honestly;
- the need to ensure that complaints against lawyers and non-lawyers are considered and clarity of responsibility for complaint handling;
- information to be given to complainants and the way in which complainants should be treated. This includes guidance on timescales for initial and subsequent communication and information about the role of the OLC and the right to appeal;
- the way in which a member of staff being complained about will be treated; and
- the importance of record keeping.

The Office for Legal Complaints and ABS Complaints

296. The OLC has been established by the Act to set up an independent and impartial Ombudsman scheme that users of legal services can go to in order to resolve disputes involving their lawyer. The Ombudsman scheme will be the single body for all consumer legal complaints, relating to both reserved or un-reserved legal activities. The LSB will work with the OLC to ensure that complaints about ABS are handled in a way that is consistent with our shared aims.

297. The OLC has published draft scheme rules that set out a proposed approach to its core role of resolving disputes involving lawyers and consumers of legal services. The OLC is consulting on these rules until 8 December 2009 and it is anticipated that it will begin to resolve complaints in the second half of 2010.

298. The OLC will consider complaints about entities and in the case of ABS, will take all service complaints relating to ABS. For multidisciplinary practices, the OLC will take complaints relating to non-lawyers and refer them to the appropriate body where necessary. This could be a major change to the current arrangements for handling consumer complaints. The LSB will work with ARs, LAs and the OLC to ensure that in any combination of business

provided by an ABS, referral of complaints to other bodies is done in a way that minimises inconvenience for the complainant.

299. The OLC is not being established to investigate issues of misconduct or to discipline lawyers or, in the case of ABS, any other individuals. Issues relating to misconduct will continue to be handled by the approved regulator, LA or the relevant other regulatory body.

Question 10

Do you think that our approach to complaints handling is suitable?

a. Do you think that ABS complaints should be handled in the same way as non-ABS complaints?

b. Do you think that ABS should be allowed to adapt their complaints handling systems if they already have one for their non-legal services consumers?

c. Do you think it is appropriate for the OLC take complaints from multi-disciplinary practice consumers and refer where necessary?

Diversity

Desired outcomes

- ABS allow the provision of legal services to develop in ways that help encourage diversity.
- Better information on diversity allows consumers a clearer insight into the providers they choose, provides individuals the information needed to make an informed decision about their careers and allows law firms to differentiate themselves in a liberalising market (for ABS and non-ABS firms).

Key proposals

300. At this stage it is not appropriate to require licensing rules to compel a licensed body to publish data on diversity, although we expect LAs to encourage publication of this information for larger ABS.

301. We may introduce a diversity requirement for LAs at a later date (if deemed appropriate) once further research into the potential benefits and harms has been conducted. Any such diversity requirement would focus on uniformity of metrics across law firms with a particular emphasis on statistics relating to progression and retention.

302. ABS and other legal services providers may, in the future, be required to meet information requirements as part of a broader strategy to increase the transparency of the legal services profession.

Relevant sections of LSA 2007

303. Section 1 (1) (f) (the regulatory objectives) and Section 28 (duty to promote the regulatory objectives).

Summary of views from Discussion Paper

304. A number of respondents identified the possibilities for a more flexible approach to working and suggested that the widening of career options may allow those from different backgrounds to enter the legal profession and also increase opportunities for existing lawyers.

305. Some predicted increased opportunities for non-lawyers, as commercial and management skills will be extremely valuable in ensuring individual ABS can position themselves within the market and respond to competition.

306. Some respondents emphasised the need to ensure that the market is not opened up at the expense of diversity. A few raised concerns that diversity would be negatively affected by ABS. These concerns were focused on the future of small firms and sole practitioners, and the potentially disproportionate impact on BME owned firms.

307. The need for further research was also highlighted by a small number of respondents to the discussion paper on ABS. One respondent emphasised the need to carry out a detailed impact assessment to consider positive and negative outcomes of ABS on diversity and another respondent suggested conducting further research on assessing the impact of corporate structures on diversity i.e. to determine if equality is assisted through the removal of partnership status. Other suggestions for further research include: assessing diversity within legal and other professions likely to be involved in ABS, a comparison of women's progression in a partnership model compared to a non-partnership model and a comparison of the gender pay gap between private, public and corporate structures. Another key point highlighted by one respondent was that there is a current lack of information on age and sexuality within the legal profession and further research could include how ABS will impact on those strands of diversity.

Discussion

308. The LSB and the approved regulators have a regulatory objective to encourage an independent, strong, diverse and effective legal profession. The LSB's over-arching philosophy on diversity issues is to help foster a cultural change in the legal profession so that minority groups are fairly represented at all levels. The ultimate goal is a culture within the legal profession where no-one is subject to arbitrary discrimination and where everyone is sensitive and respectful of identity issues. We do not consider that the introduction of non-lawyer owners and managers is likely to have an adverse impact on the diversity of the legal profession and may bring positive benefits. We consider that the risk to diversity presented by the possible closure of BME owned firms is mitigated by the ongoing need for diversity among those providing legal advice to address the needs of consumers who choose to use BME lawyers.

309. The LSB considers that, given the diversity of the profession at entry level, attention should be brought to issues of progression and retention within the providers of legal services. The LSB envisages that ABS will create avenues for individuals to pursue new career paths and create new opportunities for progression and retention for those who wish to enter, or currently work within existing legal service providers. The LSB expects that ABS will therefore play a significant role in creating a stronger, more effective and more diverse legal profession.

The LSB's role

310. The LSB believes that a diverse profession is not an end in itself, as there are a number of benefits to be gained by the legal services industry in promoting diversity both individually and collectively. Potential benefits may include:

- greater consumer trust and understanding arising from less deference towards (and in some cases even fear of) lawyers;
- an improvement in staff retention leading to lower recruitment and training costs;
- an increase in efficiency in an organisation through utilising a wider set of skills;
- a reduction in the costs of unfair treatment or discrimination claims; and
- an ability for a business to maximise talent by selecting from a wider talent pool.

311. The LSB believes that a diverse profession may also enhance a business's reputation, as employees from a variety of backgrounds can help understand the communities that they are familiar with - leading to more tailored services for consumers.

312. The LSB considers that diversity in employee make-up can bring diverse skills and perspectives which help serve a diverse consumer base and which will help to foster greater innovation within a business. In that sense, increasing workforce diversity should also help to fulfil another of the LSB's regulatory objectives: the promotion of competition.

313. The LSB is also subject to further regulatory objectives to protect and promote the public interest and the interests of consumers. The LSB believes that the public will have more confidence in a profession that reflects its make-up, and consumers will ultimately have a better service from a more representative legal profession that understands their needs. Moreover, the LSB's regulatory objective to improve access to justice requires a diverse legal profession in order to better serve the legal requirements of different types of consumers.

Our analysis

Impact on small firms and sole practitioners

314. The LSB has identified in the previous discussion paper on ABS, the importance for the LSB and approved regulators to closely monitor the implications of ABS on small firms and sole practitioners. The LSB continues to support this recommendation and would encourage further investigation into the potential and actual impact of ABS on small firms or sole practitioners. The results will help to inform a decision whether any specific diversity requirements are needed. The LSB also considers that ABS may provide opportunities for small firms and sole practitioners (whether BME owned, controlled, managed or not) to deliver a greater range of services in parallel with legal services and to attract external finance to grow their business. The LSB emphasises the need to monitor positive and negative impacts of this where possible.

ABS and the opening of new paths to progression and retention

315. The LSB believes that a major advantage of ABS will be to open up new career paths for lawyers, ensuring better retention and more diverse progression routes. Not every lawyer seeks to own their legal practice but this has been the dominant way of progressing through a legal service career.

316. This diversification of career paths has already been seen in Australia, where 'incorporated legal practices', which enable separation of ownership and management, have led to new methods of incentivising employees and new career paths for lawyers which do not have the ultimate end of partnership. The traditional partnership route requires a commitment from employees that does not necessarily fit easily with a diverse workforce. Such a commitment can be incompatible with family duties, taking career breaks, religious commitments and adjustments needed to work with disabilities.

317. The LSB also considers that structures of some ABS are likely to encourage those from non-legal backgrounds to own and manage legal service providers. This in itself has the potential to offer a pathway to senior positions within a legal service provider that was previously only available to lawyers through a traditional partner route. In a wider sense, the entry of owners, managers and employees from a non-legal background with expertise and knowledge from a range of different sectors, may create a more diverse workforce than the existing legal sector. These individuals may carry over an attitude or shared culture which comes from a professional background which could be more diverse in gender, ethnicity and social background than the legal sector at present.

318. The previous discussion paper on ABS raised the issue of the education and developmental implications of ABS. The LSB considers that in addition to providing new paths to progression and retention, ABS are likely to offer alternative paths into the professions including encouraging the entry of those from a vocational training background. This has the potential to encourage a wider pool of talent to enter the professions and may result in a culture of change in the existing legal profession where those providing legal services could only enter the profession through the traditional degree route.

319. The LSB wants to move the focus away from 'inputs' (what diversity initiatives are being undertaken) to realistic 'outputs' (how successful are such diversity initiatives).

320. Given that such research will take place, a requirement should therefore be introduced into the licensing arrangements which states that the ABS will comply with guidance issued by the LA, from time to time, on the subject of information provision on diversity. Such requirements will, in turn, be consistent with any requirements the LSB considers it appropriate to impose

on LAs and ARs on this issue. At first sight, it is difficult to see a case for imposing differential requirements on ABS alone, which are not equally relevant to entities in the rest of the legal services market.

Question 11

What are your views on our proposed course of action to conduct research and, depending on the results, either compel transparency of data or encourage it?

a. Do you agree with our position on diversity and ABS?

b. Do you agree that the overall impact is unlikely to be adverse to the diversity of the profession?

c. Do you agree that non-lawyer managers may open new career paths to lawyers and these may have a positive impact on career progression?

d. Do you agree that the demand for diverse legal professionals will, largely, offset the potential impact due to the closure of small firms?

e. Should the LSB require information about the diversity of the workforce in ABS? If so when and should this be a requirement for other legal service providers?

International issues

Desired outcome

- Increased understanding outside the UK of the range of protections afforded by the licensing framework

Key proposals

321. Given the consumer protections, there is no reason to limit English and Welsh ABS from expanding internationally.

322. We will work to inform other jurisdictions about the ABS framework and the protections it provides for lawyers and consumers

Relevant sections of LSA 2007

323. The LSA 2007 governs the legal services market in England and Wales.

Summary of views from Discussion Paper

324. Some suggested that international regulation and compatibility may pose issues for large scale ABS.

Discussion

325. Currently, the international legal framework in many jurisdictions prohibit ABS. Inevitably, this limits the size of the market of ABS. Countries that allow ABS are in the minority: for example, there are limited ABS in Spain and limited multi disciplinary practices in Germany and Italy but more comprehensive 'incorporated legal practices' (which allow for external ownership and include multidisciplinary practices) in Australia. Other countries have recently been considering adopting ABS in some form (notably Scotland and France).

326. We have been in contact with both the American Bar Association (ABA) and the Conseil des Barraux de l'Union Européens (CCBE). The CCBE has stated in its response to our discussion paper on ABS that allowing non-lawyers into a law firm could compromise lawyers' adherence to their professional principles. However, our statutory and regulatory framework seeks to mitigate that risk.

327. ABS continues a long standing process of limited de-regulation but ensures more robust protections in situations where independence may be perceived as being compromised. In this sense, ABS are in the public interest. Furthermore they enable more competitive models to emerge which should be better for consumers and, with appropriate regulation, should also improve access to justice.

328. It is an aim of the LSB to remove as many international barriers to competition as possible for the benefit of consumers and the public more generally. In principle, everyone should mutually benefit from a larger, more competitive

market. We hope that the learning experience and advice offered by engaging with foreign jurisdictions should benefit the development of our regulatory framework.

329. However, both European Court of Justice case law (Wouters v. NOVA (Case C-309/99)) and the Framework Services Directive (2006/123/EC) give other national regulators scope for restricting ABS in their markets. The safeguards inherent in ABS are viewed sceptically by several other national bars in Europe who may choose to prohibit ABS in some respects because of the perceived loss of the independence of lawyers who work within such ABS.

330. It is our view that better staff management and accounting and business management skills taken from non legal business sectors may make for better, safer structures all round. In particular, law firms which adopt a corporate ABS structure are subject to additional controls – for example:

- Companies Act 2006 directors' duties;
- disqualification of company directors;
- authorised persons' employment rights;
- stock market and accounting rules, controls and disclosures, activist shareholders and other corporate governance arrangements; and
- Head of Legal Practice and Head of Finance and Administration roles and ownership restrictions in the LSA 2007.

331. Independence of conduct and ethical behaviour are protected by the mechanisms provided for in the LSA 2007 (e.g. the fitness to own test and the Head of Legal Practice and Head of Finance and Administration, noted above). The risks to independence are already present where a lawyer depends heavily on a single source of work or has burdensome lending arrangements. ABS may provide the solutions to such business models.

Notaries

332. We are also aware that the Master of the Faculties and the Society of Scrivener Notaries have both objected to notaries working within an ABS (in their notarial capacity). They are concerned that ABS will be perceived to compromise a notary's independence and that therefore the acts of notaries may not be recognised abroad. They want to restrict the ability of a notary to participate in ABS through their code of conduct.

333. Whilst the LSB understands these concerns, we do not consider that it is appropriate for the LSB to seek to restrict the commercial decisions of notaries. If the concerns are justified then it is unlikely that notaries will choose to work in an ABS. But we will keep the matter under review in the light of any fresh evidence presented to us.

Question 12

Do you agree with our approach to international issues?

Legal Disciplinary Practices (LDP)s, Recognised Bodies and other similar entities

Desired outcome

- There is a smooth transition for firms that currently have non-lawyer managers or owners who wish to become ABS.

Key proposals

334. Existing law firms with non-lawyer owners or managers should be provided with a fixed transitional period of 12 months within which to apply for a mainstream ABS licence. During that time their regulation continues on the same basis as now.

Relevant sections of the Administration of Justice Act 1985

335. Sections 9, 9A, 32 and 32A.

Discussion

336. LDPs that are regulated by the SRA now allow up to 25% non-lawyer ownership. CLC regulated law firms can have an even greater proportion of non-lawyer managers and are much closer to the ABS regime. Both types of LDP allow partnerships of different types of lawyer (e.g. solicitor and licensed conveyancer), but restrict other types of 'multidisciplinary practice'. LDPs have been allowed since May 2009; there are already over 100 of these entities in the market. There are also around 50 CLC recognised bodies and around 40 LDPs with non-lawyer managers. In addition, there are firms that are currently regulated by other ARs that may require a licence once the ABS regime comes into force if they have both lawyer and non-lawyer owners and/or managers.

Lessons from LDPs and Recognised Bodies

337. In order to help our understanding of how the legal services market may respond to the lifting of restrictions in ownership and management that is facilitated by the introduction of ABS we have undertaken research into the LDP and CLC recognised body regime. We undertook a series of semi-structured qualitative interviews to better understand how the regime had affected LDPs. In the interviews we asked the following questions:

- What did you perceive to be the advantages and disadvantages of becoming an LDP?
- What do you see as the main successes of the LDP system?
- What have been the main difficulties you have faced?
- Would allowing barristers to join LDPs have made a difference to your experience of the LDP? If so, in what way?

- What do you see as the key challenges and opportunities for the introduction of ABS?
- Do you have any other comments about LDPs, ABS or legal regulation more generally?

338. The SRA and CLC provided a list of suitable interviewees. We selected a representative sample, ranging in size, structure, location and services provision. We approached fifteen firms and were able to speak to eight in total. Senior level lawyers and non-lawyers in the firms participated occupying a variety of roles including Managing Partners, Marketing Managers and IT Directors.

339. The smallest LDP we approached in our research had only two partners (and one part time assistant) and was formed by a solicitor and a legal executive. The larger LDPs tended to have introduced non-lawyer managers into their partnership. The detailed results of this research are in Annex E. Overall, the transition to LDPs appears to have gone smoothly.

Proposed transitional arrangements

340. Many LDPs would automatically become ABS once the relevant provisions of the Act come in to force and, as with some other entities that currently are allowed to have non-lawyer owners and managers, will not have the opportunity to make a commercial decision based on their business plan as to when to apply for a licence. We consider that it is appropriate to provide some transitional protection to LDPs to allow them to decide whether to apply for an ABS licence or whether to revert to a structure that does not require a licence. If the LDP has not done either of these things by the end of the transitional period, it would be committing an offence because it would be an ABS operating without a licence.

341. We propose that LAs should grant a special class of licence to a LDP and existing ABS-like entities. This licence would not be based on the LA's licensing rules but would replicate the regulatory framework for non-ABS entities. We consider that this transitional period should be limited to 12 months. This approach has the advantage that the regulation of ABS is all carried out under the LSA and not under the current variety of regulatory requirements.

Question 13

Should LDPs, Recognised Bodies and other similar firms have transitional arrangements into the wider ABS framework in the way we propose?

a. Is 12 months after the start of mainstream ABS sufficient time to allow this to happen?

Other issues

Duration of ABS licences and licence fees

342. In order to provide as much certainty as possible for people who want to become an ABS, the LSB considers that it is inappropriate for licences to be time-limited. we consider that the proposed requirement to notify a LA of any changes in fitness to own or licence breaches makes an annual check unnecessary.

343. The LSA 2007 makes it a requirement for an annual fee to be paid by the ABS to the LA. LAs must have regard to the regulations to be made pursuant to the Framework Services Directive which seek to ensure transparency of cost when licensing. We therefore expect licence fees to be broadly cost-reflective and to allow for different annual licence fees for different types of ABS.

344. The LSA 2007 requires a LA to make a decision whether to grant a licence within six months of first receiving the application. We expect LAs to publish their target times for assessing licence applications and to publish their performance on an ongoing basis.

345. In a minority of cases, there may be a practical obstacle to those ABS that first apply for a licence if an owner of a material interest has not been approved fit to own before that time period. The LA should therefore strive to approve applications within a six month period, although we recognise that in certain circumstances that may be challenging.

Relevant sections of the Act

346. Schedule 11 paragraph 21(1) outlines the requirement for a licensing fee, Schedule 85 relates to licence duration.

347. The Framework Services Directive (2006/123/EC) requires cost transparency in licensing/authorisation processes

Other licence terms

348. The Act allows a LA to suspend or revoke a licence according to its licensing rules. In addition to the circumstances surrounding enforcement see page 46, we consider that the terms of the licence should also specify the following as circumstances that would allow (but not require) the LA to revoke a licence:

- insolvency;
- provision of false information; or
- any other similar event

349. We do not consider that the appellate body's role should extend to appeals against revocation decisions. Rather, that should be a matter for Judicial Review.

Question 14

Should ABS licences be issued for indefinite periods?

a. Should the annual charging process be broadly cost reflective or a fixed fee?

b. How should LAs ensure ABS are continuing to comply with their licence requirements?

Regulatory overlaps

Outcomes

- A single framework Memorandum of Understanding ("MoU") is implemented by all relevant bodies and provides a mechanism to resolve overlaps in ways which:
    - provide the best form of consumer protection and redress,
    - minimise confusion for market participants, and
    - reduce/remove conflict in future.

Key proposals

350. A single framework MoU, developed through the ABS Implementation Group and to be agreed in principle by June 2010, which all ARs/LAs and relevant other regulators subscribe to and implement and which provides a mechanism to resolve overlaps.

Relevant sections of LSA 2007

351. Section 28(3) (better regulation principles) and the regulations made pursuant to the Framework Services Directive (2006/123/EC).

Summary of views from Discussion Paper

352. A common theme was the risk posed by burdensome regulation and potential regulatory overlap, and the associated cost implications of operating within an overly complex regulatory environment.

Discussion

353. Managing overlapping entity regulation will be particularly important in regulating ABS. Particular business models should not be restricted by over-burdensome double (or multiple) regulation or by inconsistent demands made by regulators. It is equally important that consumers have adequate protection when using any of the regulated services provided by an ABS and that consumers are confident that all necessary protections are in place. Managing overlapping regulations will be important for all regulators (including the LSB, should it be required to become a direct licensor).

354. It will not always proportionate to resolve conflicts in one direction with the regulatory requirements of one regulator "trumping" the other. Different business models and combinations of regulated services will pose different risks. We expect, therefore, a framework MoU will allow for different risks in different businesses to be regulated in different ways by regulators. This may even change over time as different levels of risk are identified and experience of compliance develops.

355. We consider that overlapping entity regulation should be managed by LAs and other relevant bodies in order to achieve the above outcomes. In order to

avoid a series of different MoUs between different bodies (which would be likely to increase regulatory uncertainty about how overlapping issues will be dealt with) we see the need for one framework MoU. Development of this will be facilitated by the LSB. The MoU will need to be flexible enough to accommodate new business models and risks as they emerge. We expect LAs' licensing rules to include a statement that it will sign and implement the MoU.

356. In addition to the ARs and LAs, the bodies that we have identified that may become parties to a framework MoU are:

- FSA
- Royal Institution of Chartered Surveyors (RICS)
- Land Registry
- Accountancy regulators (including the Institute of Chartered Accountants in England and Wales (ICAEW), The Institute of Chartered Accountants of Scotland (ICAS), and Association of Chartered Certified Accountants (ACCA))
- London Stock Exchange
- The Office of Fair Trading (OFT)
- OLC (for complaints handling issues)

357. We consider that the following areas may require particular attention in an MoU:

- compensation and professional indemnity;
- internal governance requirements;
- external ownership and control;
- complaints handling; and
- mediation provisions.

Question 15

Do you agree with our approach to managing regulatory overlaps?

a. Is it desirable to have a framework approach to a MoU?

b. Do you think we have identified the right bodies to develop a MoU with?

c. Do you think we have identified the right issues to include?

How to Respond

Our consultation period ends at 5 p.m. on **Friday 19 February 2010**. The consultation period has been extended to over 13 weeks to make allowance for the length of the document and the holiday period. In accordance with section 205(3) of the LSA 2007, you are given notice that any representation about the rules in the statutory instrument must be received prior to the end of this period. In framing this consultation paper, we have posed specific questions to help develop our guidance. These questions can be found in the body of this consultation paper, its Annexes and also as a consolidated list at Annex B. We would be grateful if you would reply to these questions, as well as commenting more generally on the issues raised (where relevant). Where possible please can you link your comments to specific questions or parts of the paper rather than making general statements.

We would prefer to receive responses electronically (in Microsoft Word format), but hard copy responses by post or fax are also welcome. Responses should be sent to:

Email: consultations@legalservicesboard.org.uk

Post: Mahtab Grant,
Legal Services Board,
7th Floor, Victoria House,
Southampton Row,
London WC1B 4AD

Fax: 020 7271 0051

We intend to publish all responses to this consultation on our website unless a respondent explicitly requests that a specific part of the response, or its entirety, should be kept confidential. We will record the identity of the respondent and the fact that they have submitted a confidential response in our decision document.

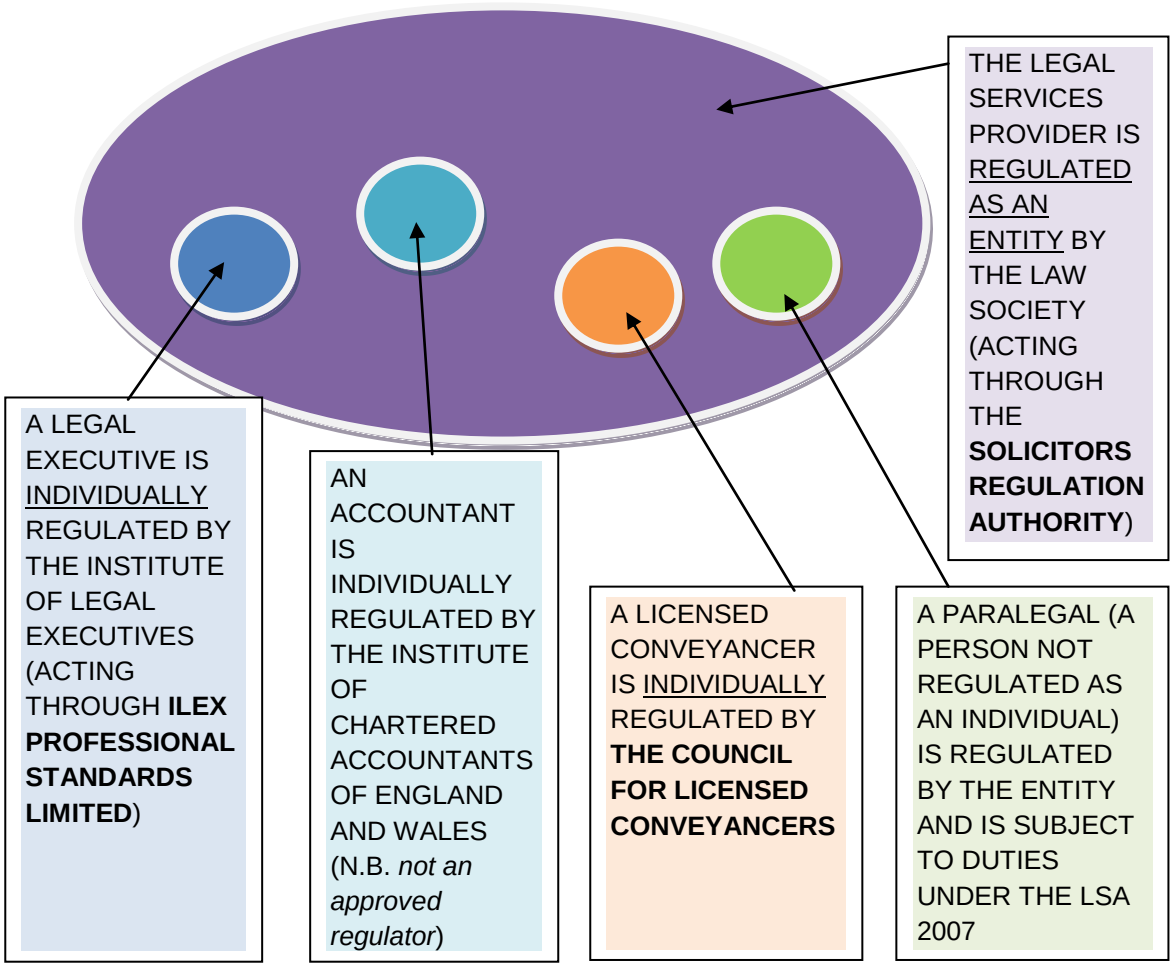
We are also keen to engage in other ways and we would welcome contact with stakeholders during the consultation period.

If you have any questions about this consultation, please contact the LSB by telephone (020 7271 0050) or by one of the methods described above.

Annex A: A diagram showing regulatory conflicts

CONFLICTS BETWEEN THE REGULATOR OF THE LEGAL SERVICES PROVIDER AND REGULATORS OF PERSONS WITHIN THE LEGAL SERVICES PROVIDER

For example:



In the case of conflict between:

> The rules of the approved regulator that regulates the entity; and
> the rules of an approved regulator that regulates an individual within the entity,

The entity regulator's rules prevail.

In the case of any conflict with a non-approved regulator (e.g. the Institute of Chartered Accountants of England and Wales), a memorandum of understanding will demarcate boundaries.

A person affected by a conflict, or a situation which gives rise to a conflict, may request that their approved regulator ask the LSB to resolve the conflict or situation (in accordance with section 53 of the LSA 2007).

Annex B: A list of questions raised in this document

1. **What is your view of basing the regulation of ABS on outcomes?**
    a. Should all LAs have the same core outcomes?
    b. Are the proposed outcomes appropriate?
    c. Is the division between entity and individual regulation appropriate?

2. **Do you think our approach set out to the tests for external ownership is appropriate?**
    a. Should the tests be consistent across all LAs?
    b. Is our suggested approach to the fitness to own test the right one?
    c. If declarations about criminal convictions are required, should these include spent convictions?
    d. What is your view of our suggested approach for considering associates? Is there an alternative approach that would work better in practice?
    e. Should there always be a requirement to declare the ultimate beneficial owner of an ABS?
    f. Overall, are any modifications needed to ensure that our approach work in a listed company?
    g. Overall, are any modifications needed to ensure that our approach work in very small companies?
    h. Do you think that the definition of restricted interest should change?
    i. Do you think that covenants should be required from those identified as having a significant influence over an ABS?
    j. How should the LSB respond to the information it receives about information on action taken against people that falls short of disqualification?

3. **Do you have views on how indemnity and compensation may work for ABS?**

    a. How should an appropriate level of PII be set for ABS that are carrying out a variety of different activities, not all of which are currently regulated by the ARs?

    b. Should there be minimum PII levels, which are the same for all LAs for different types of activity?

    c. Are Master policy arrangements appropriate for ABS?

    d. What would be appropriate arrangements for runoff and successor practices to enable sufficient commercial freedom for ABS as well as protection for consumers after practice closure?

    e. What should the requirements be for compensation funds in ABS?

    f. How could a compensation fund work in an ABS environment, in particular when the services offered by the ABS may be much wider than legal advice and where an AR may not currently have a compensation fund?

4. **Do you agree with our position on reserved and non-reserved legal activities?**

    a. Do you agree that ABS should be treated in a consistent way to non-ABS?

    b. Should all legal activities undertaken by an ABS be regulated or just reserved legal services?

    c. What role do you see consumer education playing?

    d. How should ABS which are part of a wider group of companies be treated?

5. **Are the enforcement powers for LAs suitable?**

    a. What is your view on the proposed maximum level of financial penalty that a LA can impose on an ABS?

    b. If you do not consider the proposed maximum to be appropriate what amount or formula would you propose?

    c. Will LAs have sufficient enforcement powers?

    d. Will ABS have sufficient clarity as to how the enforcement powers may be used?

e. In what circumstances should a LA be able to modify the terms of a licence?

f. Are there appropriate enforcement options for use against non-lawyer owners?

6. What do you think of our approach to access to justice?

a. Do you think the wide definition to access to justice that we have taken is appropriate?

b. Is asking an ABS on application how they anticipate that they will improve access to justice a suitable approach?

c. Do you agree that restrictions on specific types of commercial activity should not be put in place unless there is clear strong evidence of that commercial practice causing significant harm?

d. Do you agree that LAs should consider how ABS in general impact access to justice rather than trying to estimate the impact of each application singularly?

e. Do you agree that LAs should monitor access to justice?

7. What is your view of our preference for a single appeals body?

a. Should, in the future, a single body hear all legal services appeals?

b. If you don't think there should be a single body, who should hear appeals from LSB decisions should it become a LA?

c. Is the GRC an appropriate body to hear appeals?

d. What other options for the location of the body?

8. Do you agree with our approach to special bodies?

a. Do you think that special bodies' transitional arrangements should come to an end?

b. Do you think 12 months after the start of mainstream ABS is sufficient time for them to gain a full licence?

c. Do you think LAs should adapt their regulation for each special body?

d. Do you agree there are some core requirements that all special bodies should meet? If so, what do you think these are?

e. What are your views on the suggestion that the OLC should make voluntary arrangements with special bodies?

9. Do you think that our approach to HoLP and HoFA is suitable?

a. Do you think that our approach on focussing on compliance systems across the organisation is suitable?

b. Do you think that HoLP and HoFA should undergo a fit and proper test?

c. Should there be training requirements for the HoLP and HoFA?

d. Do you agree that the HoLP and HoFA could be the same individual (especially in small ABS)?

10. Do you think that our approach to complaints handling is suitable?

a. Do you think that ABS complaints should be handled in the same way as non-ABS complaints?

b. Do you think that ABS should be allowed to adapt their complaints handling systems if they already have one for their non-legal services consumers?

c. Do you think it is appropriate for the OLC take complaints from multi disciplinary practice consumers and refer where necessary?

11. What are your views on our proposed course of action to conduct research and, depending on the results, either compel transparency of data or encourage it?

a. Do you agree with our position on diversity and ABS?

b. Do you agree that the overall impact is unlikely to be adverse to the diversity of the profession?

c. Do you agree that non-lawyer managers may open new career paths to lawyers and these may have a positive impact on career progression?

d. Do you agree that the demand for diverse legal professionals will, largely, offset the potential impact due to the closure of small firms?

e. Should the LSB require information about the diversity of the workforce in ABS? If so when and should this be a requirement for other legal service providers?

12. Do you agree with our approach to international issues?

13. Should LDPs, Recognised Bodies and other similar firms have transitional arrangements into the wider ABS framework in the way we propose?

a. Is 12 months after the start of mainstream ABS sufficient time to allow this to happen?

14. Should ABS licences be issued for indefinite periods?

a. Should the annual charging process be broadly cost reflective or a fixed fee?

b. How should LAs ensure ABS are continuing to comply with their licence requirements?

15. Do you agree with our approach to managing regulatory overlaps?

a. Is it desirable to have a framework approach to a MoU?

b. Do you think we have identified the right bodies to develop a MoU with?

c. Do you think we have identified the right issues to include?

Annex C: Reserved and unreserved legal activities – a diagram

APPROVED REGULATOR/ QUASI-APPROVED REGULATORS	LEGAL ACTIVITIES* THAT ARE SUBJECT TO REGULATION						
	RESERVED LEGAL ACTIVITIES						UNRESERVED LEGAL ACTIVITIES (the extent to which the carrying out of such unreserved legal activities is regulated by the relevant approved regulator/quasi-approved regulator varies)
	The exercise of a right of audience*	The conduct of litigation*	Reserved instrument activities*	Probate activities*	The administration of oaths*	Notarial activities*	
The Law Society (acting through the SRA)	●	●	●	●	●		All unreserved legal activities given in the course of legal advice, included that provided through a separate business
The General Council of the Bar (acting through the BSB)	●	●	●	●	●		All unreserved legal activities given in the course of legal advice
The Master of the Faculties			●	●	●	●	All unreserved legal activities which form part of the notary's practice
The Institute of Legal Executives (through ILEX Professional Standards Ltd)	●				●		Where a legal executive is employed by a barrister or solicitor, all unreserved legal activities given in the course of legal advice
The Council for Licensed Conveyancers			●	●	●		All unreserved legal activities related to conveyancing or probate
The Chartered Institute of Patent Attorneys (Through IPREG)	●	●	●		●		All unreserved legal activities which form part of the relevant lawyer's practice
The Institute of Trade Mark Attorneys (Through IPREG)	●	●	●		●		All unreserved legal activities which form part of the relevant lawyer's practice
The Association of Law Costs Draftsmen	●	●			●		None, unless the unreserved legal activities are provided in such a way as to bring the Association of Law Costs Draftsmen into disrepute
The Association of Chartered Accountants				●			None, unless the unreserved legal activities are provided by someone who deems themselves competent to provide them
The Institute of Chartered Accountants of Scotland				●			None, unless the unreserved legal activities are provided by someone who deems themselves competent to provide them

Explanation of key terms in table

Legal activities

(*see section 12(3) of the LSA 2007 for the technical definition*)

A legal activity is either a '**reserved legal activity**' or a non-reserved legal activity (an '**unreserved legal activity**').

An 'unreserved legal activity' broadly consists of the provision of legal advice or assistance (i.e. advice on how to apply to law or resolve legal disputes or any associated representation before the courts so far as it is not a 'reserved legal activity').

Reserved legal activities

(*see schedule 2 to the LSA 2007 for the technical definitions*)

Right of audience

A "right of audience" means the right to appear before and address one of the 'Higher Courts of England and Wales' and includes the right to call and examine witnesses.

N.B. If someone wishes to appear before a higher court but they do not have the necessary right of audience, they may still be allowed if the judge permits it.

Conduct of litigation

The "conduct of litigation" refers to the issuing of court proceedings, the commencement, prosecution and defence of such proceedings, and the performance of any ancillary functions in relation to such proceedings.

Reserved instrument activities

This refers to preparing many documents which transfer land or otherwise alter the rights attaching to it (e.g. preparing leases or loans which use land as security).

Probate activities

"Probate activities" refers to the preparation of any papers which 'grant probate' or the grant of 'letters of administration'.

The administration of oaths

The "administration of oaths" relates to the exercise of the powers conferred on a 'commissioner for oaths' by various statutes.

Notarial activities

"Notarial activities" refers to activities which were customarily carried on by virtue of enrolment as a notary.

Annex D: Draft statutory instrument

STATUTORY INSTRUMENTS

2010 No. [●]

LEGAL SERVICES, ENGLAND AND WALES

The Legal Services Act 2007 (Maximum Penalty for Licensing Authorities) Rules 2010

Made - - - -	***
Laid before Parliament	***
Coming into force - -	***

These Rules are made in exercise of the powers conferred by sections 95(3), 204(2),(3) and (4)(b) of the Legal Services Act 2007[(1)].

The Legal Services Board has published a draft of the Rules and invited representations about them[(2)].

The Legal Services Board has had regard to representations duly made to the Board[(3)].

The Lord Chancellor has consented to the making of the Rules[(4)].

Accordingly the Legal Services Board makes the following Rules.

Citation, commencement and interpretation

1. — (1) These Rules may be cited as the Legal Services Act 2007 (Maximum Penalty for Licensing Authorities) Rules 2010.

(2) These Rules come into force on [date].

Maximum penalty

2.— (1) This rule prescribes the maximum penalty which a licensing authority may impose on a licensed body, or an employee or manager of a licensed body, in exercise of the power conferred on the licensing authority by section 95(1) of the Legal Services Act 2007 (financial penalties).

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(1) 2007 c.29.
(2) See section 205(2) and (3) of the Legal Services Act 2007 ("the 2007 Act").
(3) See section 205(4) of the 2007 Act.
(4) See section 37(5) of the 2007 Act.

(2) The maximum amount of any financial penalty which may be imposed on a licensed body or a manager or employee of a licensed body shall be an unlimited amount.

Duty to provide information required to determine the financial penalty

3.— Where a licensing authority proposes to impose a financial penalty under section 95(1) of the Legal Services Act 2007 on a licensed body or a manager or employee of a licensed body, it may request from that person such information as it reasonably considers necessary in all the circumstances of the case in order to determine the amount of the financial penalty, and that person must provide the licensing authority with the information requested as soon as reasonably practicable after the licensing authority has made the request.

Name
Legal Services Board

Date

EXPLANATORY NOTE

(This note is not part of the Order)

This Order specifies the maximum penalty which may be imposed by the Legal Services Board under section 95(3) of the Legal Services Act 2007. Section 95 provides for the imposition of financial penalties on licensed bodies in accordance with the licensing rules of a licensing authority. Financial penalties may be unlimited in amount. Paragraph 22 of schedule 11 to the Legal Services Act 2007 further requires that the licensing rules of a licensing authority must make provision as to the criteria and procedure to be applied in determining whether to impose a financial penalty and the amount of the financial penalty.

Initial impact assessment for financial penalties

Introduction

The Legal Services Board (**LSB**) is undertaking an initial impact assessment on the requirements imposed on it to prescribe the maximum financial penalty that may be imposed on licensed bodies (**ABS**) by licensing authorities (**LAs**) under section 95 of the Legal Services Act 2007 (**LSA 2007**). The overall impact will depend on the extent of compliance by relevant bodies licensed under Part 5 of the LSA 2007.

What is the problem under consideration? Why is intervention necessary?

This initial impact assessment concerns the power under section 95 of the LSA 2007, which sets out the circumstances in which a LA can impose a financial penalty and which requires (pursuant to section 95(3) of the LSA 2007) the LSB to make rules prescribing the maximum amount of a penalty that can be imposed.

What are the policy objectives and the intended effects?

The policy objectives and intended effects are that well regulated ABS will in turn lead to better access and outcomes so that:

- consumers are more confident in accessing the legal services market and can make better informed decisions about purchases; and

- cultures and systems of quality assurance are embedded throughout the legal services sector to give consumers confidence in the services they purchase.

What policy options have been considered? Please justify any preferred option

Option 1: Do nothing - this is not an option – the LSB must state the maximum financial penalty where a licensing framework exists for ABS.

Option 2: Rules as drafted for consultation -

The LSB considered three options:

- First, the option of setting a maximum penalty on a person of a multiple of their annual income and on an ABS of 10 ten times their turnover (a figure consistent with other penalties based on turnover). However, there may be circumstances in which a LA considered it appropriate to impose a far greater penalty.

- Second, the option of setting a simple figure for the maximum penalty to be imposed on an ABS or an employee or manager of an ABS. The LSB does

not consider that such an approach would be proportionate to the particular person or ABS in the same way as a formula based on income or turnover. In particular we have considered whether the current maximum level of fine for criminal offences (£5000) would be appropriate but have concluded that it is not: we consider that setting the maximum penalty for all ABS at the same level as the SRA's current maximum is too low to act as a deterrent since, unlike currently, the LA will be investigating all licence breaches, including the types of breaches that can currently be referred to the Solicitors Disciplinary Tribunal or Discipline and Appeals Committee (which have significantly greater fining powers).

- Third, the LSB's preferred position, of setting an unlimited amount as the maximum. We noted in particular that sections 66, 91, 123, and 206 of the Financial Services and Markets Act 2000 gives discretion to impose a penalty of such amount as considered appropriate by the Financial Services Authority. Similarly, the Money Laundering Regulations 2007, the Transfer of Funds (Information on the Payer) Regulations 2007, the Regulated Covered Bonds Regulations 2008, and the Payment Services Regulations 2009, give a similar power to the Financial Services Authority. This power is then limited by the Financial Services Authority's current enforcement policy which, for example, in many circumstances sets 20% of a firm's income as the maximum amount which may be levied as a penalty. The LSB considers that allowing LAs the flexibility to determine their own enforcement policy, and to change it as appropriate should circumstances of a rapidly evolving market so demand, is the most desirable option. It enables a LA to impose a large penalty on an ABS or other person, if it considers it appropriate in all the circumstances of the particular case. The LSB views the threat of a large financial penalty as a significant incentive on an ABS to ensure compliance and considers that setting the maximum penalty for all ABS at the same level as the SRA's current maximum is too low to act as a deterrent since, unlike currently, the LA will be investigating all licence breaches, including the types of breaches that can currently be referred to the Solicitors Disciplinary Tribunal or Discipline and Appeals Committee (which have significantly greater fining powers).

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

In future we may review the maximum financial penalty in the light of our other developing policies and LAs' experience of applying it.

Annual Costs

One-off (Transition): £ negligible.

Average annual cost (excluding one-off): £ negligible.

Annual Benefits

One-off: £ negligible.

Average annual benefit: £ negligible.

What is the geographic coverage of the policy/option?

England and Wales.

On what date will the policy be implemented?

It is expected that this policy will be implemented in mid-2011, when Part 5 of the LSA 2007 is commenced.

Which organisation will enforce the policy?

The Lord Chancellor sets the maximum financial penalty on the recommendation of the LSB. LAs will have the power to impose penalties.

Does enforcement comply with Hampton principles?

The LSB expects LAs' enforcement policies to comply with Hampton principles.

Will implementation go beyond minimum EU requirements?

Yes. EU requirements do not require the regulatory framework set out in the LSA 2007.

What is the value of the proposed offsetting measure per year?

Nil.

What is the value of changes in greenhouse gas emissions?

Nil.

Will the proposal have a significant impact on competition?

No.

Annual cost (£-£) per organisation (excluding on-off)

The costs of this policy are not expected to add to the overall cost of compliance by LAs. If a penalty is imposed this will be paid into the Consolidated Fund.

Micro: n/a Small: n/a Medium: n/a Large: n/a

Are any of these organisations exempt? n/a.

Impact on Admin Burdens Baseline (2005 Prices)

Increase of £: approximately nil.

Decrease of £: approximately nil.

Net Impact £: approximately nil.

Evidence Base

We have undertaken an initial impact assessment of the policy on financial penalties and the maximum amount of a penalty. We consider that the cost of these changes is significantly below the generally accepted threshold of £5 million costs, below which an impact assessment is not necessary. However, we believe that in setting out how we have considered the various elements of the impact assessment will help us consult on both our proposals and our assessment of their impact.

Competition

We expect a LA's enforcement strategy and processes to have a positive effect on competition. Compliant ABS should lead to a licensing framework which enables providers of legal services to innovate and develop services that better reflect the needs of consumers.

Small Firms Impact Test

The LAs will be required by law to take a proportionate approach to regulating smaller ABS to ensure the cost of compliance is not too burdensome. The effect of a penalty of an unlimited amount will have to be mitigated by an enforcement policy issued by the LA, not least to enable a reasonable level of insurance to be obtained by the ABS.

Legal Aid

The enforcement policy will support and enhance the delivery of the regulatory objectives at section 1 of the LSA 2007 and as such will support the legal aid market through effective competition and will enable better focus on consumers and proportionate regulation.

Race/Disability/Gender equalities

Because the LSB is an oversight regulator there is no direct impact on individuals. However, if the LSB achieves its intended outcomes, there will be a general improvement in the standard of regulation and the approach taken to it which we would expect to have a positive impact generally on the provision of legal services to all consumers, and to provide increased opportunities for all groups of those being regulated.

Human Rights

The proposed policy does not engage rights or freedoms under the Human Rights Act 1998 and the European Convention on Human Rights.

Rural Proofing

The LSB's maximum amount of any penalty is not expected to have a specific impact on rural areas.

Sustainability, carbon emissions, environment and health

There is no impact expected on sustainability, carbon emissions, environment and health.

Annex E: Key themes to emerge from LDP interviews

Notes were taken at the interviews rather than recordings, so the views presented are based on the LSB's written summaries, not verbatim quotes. Some of the firms we spoke to requested that they were not identified; we have respected that request in the interest of receiving frank and honest feedback.

Types of firms

While the CLC's recognised bodies are limited to only undertake conveyancing and probate services, LDPs exist in all parts of the legal market. The firms we spoke to carried out a variety of different types of legal activities:

- residential property licensed conveyancers;
- specialist property licensed conveyancers;
- property services firms;
- business and general immigration, family, corporate and commercial firms;
- general solicitors e.g. criminal, civil, family, motoring, probate;
- high street law practice – family, conveyancing, small scale commercial practice, personal injury (no crime and no publically funded work);
- personal Injury and Clinical Negligence specialists;
- white collar crime specialists; and
- publically funded legal work specialists.

The process of becoming a LDP or recognised body

All respondents said that the administrative transition to becoming an LDP had been reasonably smooth.

One firm commented that is was a very straightforward process, especially if you were not bringing in external, non-lawyer owners.

However, one firm commented that some other ILEX members had been led to believe by their partnerships that it was extremely difficult to become an LDP.

One very small conveyance firm drew attention to the 'unnecessary' and 'excessive' bureaucracy of becoming a recognised body.

Advantages

The most common comment was that being an LDP had enabled firms to bring in a wider range of skills and therefore had made them more dynamic entities in the legal market.

Some said that opening up firms to new management structures and skills might also help to positively change public perception of firms and legal service provision in general, the LDP structure had made 'more sense' to clients.

A large firm said that in practice the change to LDP had made little difference to their day-to-day operations or management structure, since the pre-LDP status of non-lawyer employee (now managing partner under LDP) had provided the same benefits to the individual concerned and to the firm.

One firm commented that when dealing with outside organisations “Managing Director” carried more weight and was more recognisable than “Practice Director”.

A conveyancing firm said that broadening the skills of the management team had helped facilitate an ambitious IT programme, particularly with regard to giving the firm a prominent web presence.

Most said that nothing much had changed in terms of the operations of their firms – but becoming an LDP had ‘legitimised’ their structures, which was useful.

Disadvantages

No significant disadvantages were identified other than conveyancing firms saying that they had felt the bureaucracy involved in becoming a CLC regulated recognised body had been burdensome and that the CLC had seemed much more hands on in its regulatory approach than the SRA.

Main successes

Most said it was too early to assess, but the main success (as highlighted under advantages) was the opening of the profession to a wider range of skills.

One interviewee commented that it enabled non-solicitors who may be acting as partners to be formally recognised, a change they had been waiting for some time.

Another interviewee said becoming an LDP had meant that an unofficial partner in the firm was now a formal partner.

Difficulties

Most interviewees said they had not experienced any major difficulties, perhaps some isolated obstacles (for example, a CEO of one firm was the only non-lawyer and this caused some issues in terms of professional recognition).

On allowing barristers to join

Most did not consider that letting barristers join ABS would present problems or issues.

One expressed concern about the financial model, and asked whether there would be enough incentive for barristers to leave the sole trader model. However, the point was also made that more barristers (especially new entrants) would begin to be prepared to be employed once the ABS system had become embedded.

Another issue cited was whether a firm would have enough work to employ one full time barrister.

A common theme to emerge in most interviews was that the public did not care what status or role individuals were in a firm, as long as they were getting a good level of service – trust was implicit.

Key opportunities of ABS

One commented that a 'one-stop-shop - model would benefit consumers.

A non-conveyancing firm said that the threat to smaller firms would primarily be to those practising in conveyancing/probate/wills (which they considered were not completely 'legal processes'). Such areas lent themselves more to a one-stop-shop model than more complex civil legal activities.

Others identified the benefit that a more diverse workforce ABS would bring.

An interviewee said that their firm had been contacted by a smaller firm regarding the possibility of 'joining up' with them with a view to strengthening their position in the market under a future ABS regime (thereby obtaining economies of scale).

A conveyancing interviewee said they envisaged an ABS future where a conveyancing firm might combine with estate agents and surveyors to provide an all encompassing property service.

Key challenges of ABS

Several challenges were cited by all interviewees. The main ones were:

- ensuring the licensing regime for ABS is not too complicated and there are not too many regulators (regulatory overlap);
- enhancing public understanding of ABS and the regulatory regime to make informed decisions;
- concerns about conflict of interest – in particular whether there would be a trade off between costs and quality;
- however, one firm believed that there were no greater ethical/financial/propriety risks from ABS than from traditional practices and that no ABS specific regulation was required. Internal ABS management structures could deal with risks and individual practitioner actions would come within the remit of AR rules;
- big changes in the market, danger of dominance by a few big players;
- decline of the traditional model;
- emergence of firms (especially in conveyance) providing 'national' level services – a challenge for small local firms; and
- one firm believed that ABS could be harmful to ILEX members due to consumers going straight to services provided by non-lawyers rather than legal executives.

Annex F: Glossary of key terms

A

"ABA" – American Bar Association

"ABS" – Alternative Business Structures

"ACCA" – Association of Chartered Certified Accountants

"AJA 1985" – Administration of Justice Act 1985

"AR" or **"approved regulator"** – a body which is designated as an approved regulator by Parts 1 or 2 of schedule 4, and whose regulatory arrangements are approved for the purposes of the LSA and which may authorise persons to carry on any activity which is a reserved legal activity in respect of which it is a relevant AR

"ARP" – Assigned Risks Pool

B

"BME" – Black, Minority and Ethnic

"BSB" – The Bar Standards Board

C

"CCBE" – Conseil des Barraux de l'Union Européens

"CEO" – Chief Executive Officer

"CLC" – the Council for Licensed Conveyancers

"CPD" – Continuing Professional Development

D

"DAC" – Discipline and Appeals Committee of the CLC

F

"Framework Services Directive" – Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market

"FSA" – Financial Services Authority

"FSMA 2000" – Financial Services and Markets Act 2000

G

"GRC" – General Regulatory Council

H

"HR" – Human Resources

"HoFA" – Head of Finance and Administration

"HoLP" – Head of Legal Practice

I

"ICAEW" – Institute of Chartered Accountants of England and Wales

"ICAS" – Institute of Chartered Accountants of Scotland

"ILEX" – Institute of Legal Executives

L

"LA" or **"licensing authority"** – an AR which is designated as a licensing authority under Part 1 of schedule 10 to the LSA and whose licensing rules are approved for the purposes of the LSA

"LSB" or **"the Board"** –Legal Services Board

"LDP" – Legal Disciplinary Practice

"LSA" or "**the Act**"– Legal Services Act 2007

M

"MoU" – Memorandum of Understanding

O

"OFT" – Office of Fair Trading

"OLC" – Office for Legal Complaints

P

"PII" – Professional Indemnity Insurance

R

"RICS" – Royal Institute of Chartered Surveyors

S

"SDT" – Solicitors Disciplinary Tribunal

"SRA" –Solicitors Regulation Authority