APPLICATION MADE BY THE SOLICITORS REGULATION AUTHORITY BOARD TO THE LEGAL SERVICES BOARD UNDER PART 3 OF SCHEDULE 4 TO THE LEGAL SERVICES ACT FOR THE APPROVAL OF:

- **THE SRA INDEMNITY INSURANCE RULES 2014 (INCLUDING THE MINIMUM TERMS AND CONDITIONS OF COVER)**
- **THE SRA AMENDMENTS TO REGULATORY ARRANGEMENTS (MISCELLANEOUS NO.1) RULES 2014**

A PROPOSED ALTERATIONS

1. This application involves changes to the SRA Indemnity Insurance Rules (**SIIR**) and the Minimum Terms and Conditions (**MTC**) (set out in Appendix 1 to the SIIR). The principal changes are the introduction of a new Outcome in the SRA Code of Conduct 2011 (**the Code**) which requires firms to assess and purchase an appropriate level of professional indemnity insurance (**PII**), this will deliver appropriate, targeted and proportionate protection for all consumers. It is complemented by the proposed reduction of the minimum level of compulsory cover to £500,000 for any one claim, which will provide a proportionate fall back protection. In addition there are changes to the SRA Handbook Glossary 2012 (**the Glossary**) for the purposes of introducing new definitions and either amending or deleting some of the existing definitions contained in the Glossary.

2. If approved, the changes will come into effect at the start of the next annual professional indemnity insurance period on 1 October 2014 (which will run until 30 September 2015). If the changes are approved after 31 August it is unlikely that the market will have sufficient time to respond in time for them to take effect on 1 October, the date on which most firms are due to renew their cover. Although there may be some scope for firms to renew under the existing arrangements for a shorter interim period.

B NATURE AND EFFECT OF THE SRA's CURRENT ARRANGEMENTS

Qualifying Insurance

3. Principals in a firm carrying on private practice from offices in England and Wales are required to have compulsory professional indemnity insurance in compliance with the SIIR and MTC. The SIIR apply to solicitors, registered European lawyers, registered foreign lawyers, licensed bodies (and their managers) and recognised bodies (and their managers). For ease, the term “solicitors” shall be used in this application. The main purpose of the insurance is to provide the public with a very good basic level of protection in the event that a firm is negligent or dishonest which results in a financial loss.

4. The breadth of cover, and the inability of participating insurers to avoid cover, is unparalleled in the commercial professional indemnity insurance market.

This is because the cover closely matches the cover provided under the previous compulsory professional indemnity arrangements (in place until 31 August 2000) based on a statutory fund called the Solicitors Indemnity Fund (**SIF**).

Claims Made Basis of Insurance

5. Professional indemnity policies are written on a “claims made” basis rather than a “losses occurring” basis. This means that responsibility for paying a claim lies with the insurer at the time the claim arises, or circumstances which may give rise to a claim are notified, rather than with the insurer that was on cover when the alleged negligent act took place. This is a very important distinction between professional indemnity insurance and many forms of insurance. So long as there was a single compulsory scheme with one insurer, as with SIF, this distinction was relatively unimportant. Under the current market based scheme it is crucial.

Minimum Terms and Conditions

6. The key terms of the MTC include:

   (a) Cover is for all civil liability arising from private legal practice, with only limited permitted exclusions;
   (b) The insured includes the firm (and any prior practice) together with any current or former principal and employee;
   (c) The definition of "firm" includes any "licensed body" in respect of its regulated activities;
   (d) Cover extends to the practice as a whole including any body corporate;
   (e) Cover extends to all activities permitted to a solicitor in England and Wales;
   (f) The current minimum sum insured is £2 million any one claim for sole practitioners and partnerships and £3 million any one claim for limited companies and Limited Liability Partnerships (**LLPs**)[1];
   (g) The minimum sum insured is exclusive of defence costs which are covered in addition without financial limit;
   (h) Participating insurers are prohibited from avoiding or repudiating the insurance on any grounds whatsoever including non-disclosure, misrepresentation and failure to pay premium (although they may have rights of reimbursement against each insured);
   (i) The dishonesty exclusion only applies to the dishonest member(s) of the firm so that innocent partners are covered. If all the principals of the firm have been dishonest then the claim falls to be dealt with by the SRA’s Compensation Fund;
   (j) If a firm ceases without successor practice then the policy is automatically extended by six years to provide run-off cover.

[1] When giving his concurrence with the Solicitors' Incorporated Practice Rules 1988 the then Master of the Rolls required that a recognised body that was a company limited by shares should have top up cover above the £1m per claim provided by SIF of either £500,000 per claim or £2m per annum on an aggregate basis. In 2005 the minimum sum insured for any one claim was increased to £3million for firms that were LLPs or companies limited by shares. This replaced the previous top up requirement. For all other practices the minimum sum insured for any one claim was doubled to £2million. These increases were linked to the introduction of a new aggregation provision with effect from 1 October 2005.

Run-off Cover

7. The scheme provides for automatic run-off cover for at least six years following the closure of a firm in the following ways:

   (a) If a firm closed without successor practice on or before 31 August 2000 then the SIF continues to provide run-off cover in accordance with the arrangement that was in place until the Qualifying Insurance scheme was introduced from 1 September 2000;
   (b) If a firm closes without successor practice on or after 1 September 2000 then the qualifying insurer / participating insurer (or the ARP) on risk at the date of closure is required to provide cover for the balance of the indemnity year and for a further six years thereafter. At the end of the six years so called "post six year run-off cover" is provided by SIF currently until 30 September 2020;
   (c) If a firm closes due to a succession by a successor practice then any future claims arising from the ceased firm will be covered by the qualifying insurer / participating insurer on risk for the successor practice at the date the claim is made.

Participating Insurers

8. Qualifying Insurance is available through participating insurers. All insurers authorised to conduct business in the UK can become a participating insurer provided they sign a Participating Insurer's Agreement (**PIA**) each year which incorporates the SRA Indemnity Insurance Rules and MTC. Under the PIA participating insurers have to agree to:

   - issue policies that comply with the MTC;
   - report suspected dishonesty to the SRA; and
   - arbitration arrangements for disputes between insurers.

9. There are currently 32 participating insurers. Individual participating insurers are under no obligation to offer terms to all firms. For example some insurers will offer terms to sole principals and small firms (up to three principals) while others will choose not to. Existing firms that cannot get cover on the commercial market can enter a 90 days extended policy period with their current insurer.

C. NATURE AND EFFECT OF THE PROPOSED AMENDMENTS TO THE CURRENT ARRANGEMENTS

10. A copy of the SRA Amendments to Regulatory Arrangements (Miscellaneous No.1) Rules 2014 is attached at **Annex 3** which sets outs the amendments to the Code and to the Glossary. A copy of the SIIR 2014 is attached at **Annex 1** and a copy showing the proposed changes as compared to the current SIIR is attached at **Annex 2**

11. A new Outcome O(7.13) in the Code places an express obligation on firms to assess and purchase an appropriate level of PII cover (see **Annex 3**).

12. The key changes to the Glossary are as follows:

(a) the insertion of amended definitions of "cessation", "qualifying insurance" and "sum insured";

(b) the insertion of a definition of “Insurance Mediation Directive";

(c) the deletion of redundant definitions following the reduction in the minimum level of cover; and

(d) a number of minor corrections and updates to existing definitions have been made as set out in **Annex 3**.

13. The key change in the SIIR and MTC as compared to the SIIR 2013 and MTC 2013 is as follows:

(a) **minimum level of cover** - the minimum amount of cover for any one claim has been reduced to £500,000 unless the claim relates to any insurance mediation activity in which case the limit relating to such activities is the amount required to comply with the requirements of the Insurance Mediation Directive applicable at outset, extension or renewal of the policy. This is currently € 1,120,200. Changes have been made in the MTC (clause 2.1).

14. Other changes to the SIIR and MTC as compared to the SIIR 2013 and MTC 2013 are as follows:

(a) **variations to multi year policies** - all policies will be required to be updated to reflect any amendments made to the MTC, the SIIR and the Glossary. Such amendment is to occur on the next inception, renewal replacement or extension of a policy or 18 months after the date of the last required amendment or commencement of the policy. This requirement will not apply where the date on which amendment would have been required falls within the Extended Indemnity Period or the Cessation Period. Changes have been made to clauses 4.11 and 4.12 of the MTC;

(b) **run-off cover on cessation** - the relevant clauses in the MTC have been expanded to clarify that run-off cover is to be provided on a cessation (whether during the policy period, the extended indemnity period or the cessation period) and from the expiration of the cessation period. The cover does not extend to acts or omission of the insured firm that arise after the expiration of the cessation period. Changes have been made to clauses 5.4 and 5.5 of the MTC;

(c) **international sanctions** - a sanctions exclusion has been included in the MTC. The exclusion will operate so that there is deemed to be no cover, and the Participating Insurer will not be liable to pay out a claim, if the Participating Insurer is prohibited from paying out such a claim or providing such insurance by reason of: (i) economic sanction, or (ii) trade sanction law, of the UN, EU, Australia or USA. A new clause 6.11 has been added to the MTC.

D. RATIONALE FOR THE PROPOSED AMENDMENTS

15. The SRA Board's recent policy statement "Approach to regulation and its reform" sets out a clear framework and rationale for a programme of reform. The statement outlines an immediate programme of work designed to:

- remove unnecessary regulatory barriers and restrictions and enable increased competition, innovation and growth to better serve the consumers of legal services;
- reduce unnecessary regulatory burdens and cost on regulated firms;
- ensure that regulation is properly targeted and proportionate for all solicitors and regulated businesses, particularly small businesses.

16. One of the major elements of this programme are proposed changes to the arrangements for compulsory PII for regulated entities to ensure that the minimum requirements set for firms by the SRA are proportionate whilst maintaining protection for the public, particularly individuals and small businesses.

17. The proposed changes to the minimum sum insured and to the Code are designed to ensure that regulation is proportionate and targeted. We consider that the proposed changes should assist smaller firms to provide an appropriate level of protection to clients without the need to purchase unnecessary levels of cover. In some cases firms will need to maintain cover at levels that exceed the current minimum of £2 million for any one claim (£3 million for LLPs and limited companies). Overall these measures are designed to reduce costs for firms including small and new legal services providers and their clients, who should be provided with better cover from those firms that currently under-insure. The proposed changes will provide a degree of flexibility that is absent at the moment and will make it easier for new firms and insurers to enter the market.

18. The proposal~~s~~ to introduce a new Outcome in the Code and to reduce the minimum cover requirements were part of a wider package of reforms. The SRA Board, taking into account the views of respondents to the consultation on these reforms, decided to allow further time to consider some of the proposed changes. The Board decided it could safely proceed with the two proposals set out in this application and we are satisfied that the changes will not adversely affect the market at the October renewal.

19. We have considered whether to delay these proposals for a period (such as a year) taking into account a range of factors. Those that supported the changes clearly want to benefit quickly whereas at least part of the opposition was either an in-principle opposition or an argument that it would not reduce costs. Neither of these are good reasons to delay. Some did argue that the changes would lead to difficulty because firms could not assess their risk in the timeframe available. We do not accept that is a significant issue because (a) we know that many firms already assess the need for additional cover; (b) firms should have their claims history as part of getting any quotes, (c) firms will need to know their work profile in order to manage a range of other risks. Our conclusion is that while other proposals should not be introduced for October 2014, the potential benefits available for consumers and firms from these proposals should be made available quickly.

20. In reaching this decision we considered not only the many consultation responses and further analysis. We also noted the LSB decision to accept £500k minimum level of cover (without any duty to have appropriate cover beyond that level) for ICAEW. This is not of course definitive and the circumstances are different, not least as our regulatory remit goes much further than probate. We also noted the Consumer Panel's response to the ICAEW designation application on PII cover (it did not object £500k) and its analysis on McKenzie friends.

E. STATEMENT IN RESPECT OF THE REGULATORY OBJECTIVES

Protecting and promoting the public interest

21. The rationale for our changing approach to regulation is the need to focus on consumers that need regulatory protection, to reduce costs of regulation and compliance and to reduce barriers to entry to the market.

Supporting the constitutional principle of the rule of law

22. These proposals will have a neutral impact on the constitutional principle of the rule of law.

Improving access to justice

23. These measures are part of a wider package of reforms to reduce costs for legal services providers and their clients. Of themselves these proposals are expected to help reduce the cost of PII. The proposed changes will provide a degree of flexibility that is absent at the moment and will make it easier for new firms and insurers to enter the market. The combination of reduced costs and new legal services providers will help improve access to justice for those who are the least well off members of society. Although we recognise that decreasing regulatory burdens and increasing access to justice for consumers is not a question of taking one step – it will take a series of incremental reforms and this policy change needs to be seen in that context. However, we recognise that, when taken together, incremental or marginal changes can have a significant impact. In its response to our consultation the Law Centres Federation suggested that our proposals were a important part of a move to more proportionate regulation for 'low risk' providers and ensuring that any protection is focussed on the most vulnerable clients.

24. Research has shown that both individual consumers and small businesses[2] currently struggle to access affordable legal services. These individual consumers tend to be among the poorest and most disempowered of consumers and those just above legal aid eligibility levels. This poor access to the legal market is not a risk but an issue. For small firms, access to legal services in a broad sense is recognised in the research as a central to protecting and developing their businesses.

25. Findings from the 2010 English and Welsh Civil and Social Justice Survey demonstrated a link between income and the likelihood of using professional legal services, indicating that, after taking account of problem type, for problem types where legal aid is most available, people eligible for legal aid

[2] See 2013 'Small business legal needs survey' https://research.legalservicesboard.org.uk/reports/consumers-unmet-legal-needs/

are significantly more likely to use lawyers than those on low incomes, but not eligible for legal aid. Which suggests that affordability is a key driver of a decision to access legal services.

Protecting and promoting the interests of consumers

26. The new Outcome will provide additional client protection as it imposes an obligation to have PII cover, if appropriate, beyond the existing minimum. However, we consider below whether reducing the minimum level of cover is likely to have an adverse impact on the interest of consumers.

27. We have looked at the likely impact on claims in key areas of work. Our estimate is that around 50 conveyancing and probate consumers per annum (in total) might make a claim on PII over £500k and of course firms handling these sorts of transactions are not only likely but expected in most cases under our proposed change to the Code to have additional layers of insurance.

28. Conveyancing has long been a source of PII claims but this has to be set in context. The average house price in England and Wales is £169,470 and in London it is £417,389[3]. An analysis of claims data from the Solicitors Indemnity Fund (SIF) over a five year period prior to 2000 indicates that only 0.22% of conveyancing transactions result in a claim. The average value of settled claims expressed as a percentage of average house prices over the five years was 41.4%.

29. Allowing for the increase in house prices and applying the SIF pattern of conveyancing claims by value we estimate that over 99.99% of conveyancing claims would fall with the £500,000 limit.

30. The number of payments made by the Compensation Fund that are related to conveyancing and over £500k echo this - in 2013 there were just 2 such cases.

31. Our further analysis, projecting forward, suggests the number of claims would not increase materially, but we think the data is not sufficiently robust and so do not seek to rely on it.

32. As regards probate matters the latest figures from HMRC show that over 90% of estates are valued at less than £500,000[4]. Of course, the fact that an estate is over that amount does not mean that any claim will automatically translate to the full amount. We sought to undertake similar analysis for probate but were restricted by availability of data. We do not have PII data for probate, so in this case we started with the Compensation Fund. The pattern of claims to the Fund related to probate is reasonably consistent averaging 116 in recent years. In 2013 there was just one payment in excess of £500k. We compared the numbers of compensation fund cases in conveyancing to the number of PII cases and if the relationship or pattern between payments from the Compensation Fund and PII were similar in probate this would suggest that perhaps 15 to 20 PII claims per annum might be over £500,000.

[3] http://www.landregistry.gov.uk/public/information/public-data/hpi-background
[4] https://www.gov.uk/government/publications/inheritance-tax-estates-notified-for-probate-numbers-and-tax-by-range-of-estate-for-years-of-death

The relationship may be different of course, but the analysis shows that the number of consumers affected by the reduction to £500,000 is clearly small whatever area of law we consider.

33. We have considered also data prepared by Charles River Associates in their 2010 report "Review of SRA client financial protection arrangements". This considered data obtained from Association of British Insurers (ABI) and suggested that 23% of claims (not payments) made by value were for sums in excess of £1 million. The consultation has been very helpful in understanding what insurers and brokers in the market anticipate that the likely impact will be (as this also informs us of likely impact upon the insurance cover available for client claims). These responses indicate that the likely impact upon consumers would be less than the Charles River data would suggest. Our analysis above confirms this.

34. No regulatory system can provide 100% protection for all clients in all circumstances, and any that tries to do so will lead to services being priced at a level that makes them inaccessible. There needs to be an appropriate balance between client protection and access. We consider that those with probate and conveyancing transactions over £500,000 are unlikely to form part of the most vulnerable client groups.

35. As set out in paragraph 5, the key feature of claims made cover is that responsibility for paying a claim lies with the insurer at the time the claim arises, or circumstances which may give rise to a claim are notified, rather than with the insurer that was on cover when the alleged negligent act took place. Reducing the minimum cover to £500,000 has therefore given rise to a question about the position of clients who have instructed solicitors in the expectation that the minimum insurance cover of £2/3m was in place. Of course this is not a new issue - currently firms with top up cover above the MTC level can cancel that cover either because it becomes too expensive or they stop the work that requires the higher cover notwithstanding that PII is written on a claims made basis. However, the introduction of an obligation to have in place appropriate cover is expected to include an assessment of the areas of work the firm undertakes, and has undertaken, which will include consideration of current, future and past clients. So we expect that firms whose business might give rise to claims of between £500,000 and £2/3m will maintain that cover.

36. In any event, should firms not maintain appropriate cover, the impact is likely to be relatively small because those affected will be the subset of clients whose circumstances give rise to a claim; where that claim falls between £500,000 and £2/3m; and where the solicitor concerned has not taken out cover in excess of the minimum.

37. Issues have been raised about clients with catastrophic injuries whose damages will exceed over £500,000. We would expect firms that specialise in these cases to arrange appropriate levels of insurance in accordance with the Outcome in the Code. Of course, firms will also have a self-interest in arranging the level of cover that is appropriate to them – and insurers will take into account work profile when offering levels of cover and, as we note later in this paper, many firms take cover in excess of the current minimum. It is important to stress that the £500,000 level is a minimum – not a new default position.

38. The Legal Services Consumer Panel has called specifically for an information duty on the part of the solicitor in order to protect consumers whose potential negligence claim may not be insured. Firms are already under an obligation to act in their clients' best interest and while we acknowledge the importance of ensuring that clients are in a position to make an informed choice about their legal matter, we have some concerns as to the proportionality of introducing more prescriptive obligations than those already in place. The focus of these changes is to place responsibility on the firm to have appropriate cover rather than to pass the risk of not having it on to the consumer. There is little evidence to support the view that consumers make choices based on levels of cover, or that they check such cover, and we are yet to be convinced that the provision of information greatly affects consumer behaviour in similar markets. We are also mindful that imposing a formal information duty would need to include a wide range other information, in order to avoid prominence to this issue, at the expense of other risks which arise from transactions. We are aware of research published by the LBS[5] and, based on this, will consider consumers' information needs in the coming year.

39. There is some evidence that BME consumers tend to be advised by smaller firms. Thus it is at least arguable that BME consumers will gain from improved access to the legal market if costs can be pushed down for the firms that serve them.

40. In one piece of research looking specifically at ethnicity of individual and adviser we find that: "An analysis of the client profiles for civil legal aid contractors shows that 38.5% of BME clients chose BME managed suppliers and 51.2% chose white managed suppliers, a further 10.3% of BME clients chose firms with split control. Whereas 3.9% of white clients went to BME firms and 92.5% went to white firms and 3.6% to suppliers with split management control. This analysis also shows that of the 165 BME suppliers, 77.2% of clients are BME. Of the 1,368 white managed suppliers 84.2% of clients are white. Of the 67 suppliers with split control the client profile is also split 51% white and 49% BME."[6].

41. However, research into criminal legal aid in 2010 found that when asked what factors were important to them when choosing a solicitor, only seven out of 1,142 respondents referred to ethnicity. When responding to the two open-ended questions regarding the choice and use of a solicitor, only three users in total referred to the importance of language.[7]

42. Our view is that we are more likely to improve access for BME consumers if we have a diverse legal market where BME lawyers can innovate and grow. This is more likely if costs are pushed down and regulatory burdens reduced. This measure is but one small contribution to that process. It is difficult to set timescales for this within a dynamic market. We are currently preparing a new three year strategy for regulatory reform with a particular focus on liberalisation and deregulation to underpin this.

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[5] Understanding Decision Making in Legal Services: Lessons from Behavioural Economics Professor John Maule, June 2013

[6] Research on Ethnic Diversity among suppliers of Legal Aid services Legal Services Commission 2006.

[7] Transforming legal aid: Access to criminal defence services Dr Vicky Kemp Legal Services Research Centre 2010

43. In seeking to achieve a careful balance between the benefits of wider consumer access with the risk that some firms will not behave ethically, or might make mistakes, our proposal provides for targeted and proportionate protections for consumers.

Promoting competition in the provision of services

44. These proposals should promote competition by reducing barriers to entry to the legal services market and to the solicitors' professional indemnity insurance market. Increasing competition should help to drive down costs to consumers and firms alike.

45. Marsh UK have advised the SRA that they anticipate premium savings from the new claims limit will range from 5% to 15% although they are more likely to be at the lower end of the range. In its response participating insurer QBE estimates likely premium reductions of no more than circa 15% at best. We do not consider that as an initial step in reforming the market such a price reduction is insignificant, especially for a small firm. Overall prices will be driven partly by competition, and if one insurer offers reductions others might follow or lose market share. In responding to our consultation, one firm commented that when they moved from sole practice to limited company, their insurer raised their premium, 'not because we were higher risk but simply because the rules required us to have £3m cover instead of £2m'.

46. We also take the view that these changes assist small firms, delivering low risk services, to compete in the developing legal market - because it does not impose costs on smaller firms that are based on risks attributable to different or larger firms. As noted previously, in its response to our consultation the Law Centres Federation suggested that our proposals were a important part of a move to more proportionate regulation for 'low risk' providers and ensuring that any protection is focussed on the most vulnerable clients.

47. We anticipate the reduction in limit will have most impact for 1-4 partner firms on the basis that 92% of sole practitioners and 71% of 2-4 partner firms only purchase the compulsory indemnity limits[8]. Beyond that level take up of top-up insurance increases significantly from 66% of 5-10 partner firms to 93% of 11-25 partner firms. For many smaller firms we would expect £500,000 would be sufficient to meet the cost of the vast majority of claims, particularly as legal costs are payable in addition to the limit. There are exceptions, such as small boutique City firms who may need greater levels of insurance, which is why targeted and proportionate arrangements leave firms the space to make sensible decisions.

48. What this demonstrates is that the current limit of £2m / £3m is set at a level that is appropriate for only a limited number of firms. For many small firms it exceeds their needs whilst for the majority of firms above four partners the current limits are insufficient. Some have argued that the cost of cover lies in the first £500,000 - of course the fact that top-up cover is not free belies this to some extent. It might be arguable that within £2m/£3m it is the first £500k that sets the premium but when cover increased from £1m to £2m it is estimated that cost went up by around 5% and the experience of the consultation respondent mentioned above at paragraph 42 further illustrates

[8] Law Society Professional Indemnity insurance Research 2013-14, February 2014, p. 38

that the insurance industry does not take on additional risk at no cost, or to put it another way, does not offer free insurance.

49. As far as the solicitors' compulsory PII market is concerned, we are not aware that any of the existing participating insurers are intending to exit the market. We are aware of one new entrant and another possible new entrant. Further reform of the minimum terms and conditions may further assist in this regard.

Encouraging an independent, strong, diverse and effective legal profession

50. These proposals will be part of a series of steps to make regulation simpler and more affordable including for small firms. In our view it is the smaller firms that are most likely to be able to benefit from reduction in the compulsory limit from £2/ £3m. BME solicitors are disproportionately represented in small solicitor practices[9] so these proposals should have particular benefits to BME solicitors and the communities they serve.

51. The table below shows turnover (gross fee income) , it is based on data which is held by the SRA as at 14 May 2014 and is based on turnover data provided by Law Practices as part of the 13-14 annual renewal exercise.

Turnover £	Number of firms	% of total
0-200k	4680	44%
200-400k	1642	16%
400-600k	939	9%
Over 600k	3085	29%
Null turnover	201	2%
Total	10547	100%

52. The Law Society's 2013-4 PII survey stated as follows:

> "Gross fee income in the past 12 months is shown to be the dominant determinate of the level of PII premiums paid. The analysis shows that if gross fee income increases by tenfold, PII premiums increase by approximately 3.1 times, whereas if gross fees are quadrupled, then PII premiums approximately double. The regression analysis also shows that any involvement in residential conveyancing and business and commercial affairs pushes up the PII premium by a moderate but significant amount, and that an increased proportion of fees derived from residential conveyancing and probate, wills and trusts pushes up the PII premium by a small but significant amount
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> ….the cost of premiums remains by far the most important factor in decisions about which insurer to use for nearly all firms. A higher

[9] 50.5% of BME solicitors work in sole practices or firms with 2 to 4 partners compared to 28.7% of White European solicitors and 30% of BME solicitors work in firms with 26 or more partners compared with 42.6% of White European solicitors. https://research.legalservicesboard.org.uk/wp-content/media/Review-of-published-evidence-on-the-equality-of-pay-in-legal-services-Final.pdf

proportion of sole practitioners gave cost as the most important factor in their decision.

The average proportion of gross fee income spent on PII has increased from 3.6 per cent last year to 4.6 per cent this year.

Small firms, however, once more experienced a slight fall in the cost of PII as a percentage of gross fee income. As in previous years, smaller firms still spent a greater proportion of gross fee income on PII (sole practitioners paid a median 5.6 per cent, compared with 4.6 per cent across all firms)."

53. We have particularly considered the impact on small firms that carry out conveyancing in light of the representations made. The Council of Mortgage Lenders (**CML**) has suggested that its members may seek legal services from other providers or bring the work in-house if the proposals go ahead. Alternatively the CML anticipates that 'top-up' cover will be required of its panel members and questions whether this will be available. It has also been suggested that lenders may react by limiting lending panels to those with higher levels of cover and that this combined with the proposed changes to access to the Compensation Fund may lead to lenders selecting to do business with larger businesses where they may consider their risk of exposure is lower. Two insurers stated that they will not offer cover as low as £500,000. However we are not proceeding with the proposals to introduce an annual cap on insurers' exposure and excluding corporate claimants from the MTC, not least because this will provide the Law Society, lenders and others with an interest time to agree what private commercial arrangements are appropriate between these law firms and their sophisticated consumers (i.e. the lenders).

54. In considering the potential impact on those firms or their clients, we note:

- As stated above the Law Society survey shows that the dominant factor in driving PII fees is gross turnover – although involvement in residential conveyancing pushes up fees by a 'moderate but significant amount'
- As set out above, the number of conveyancing claims exceeding the new minimum is likely to be very small.
- In relation to the risk of small firms being removed from panels, a number of large lenders have stated to us that they remain committed to maintaining a large panel of firms regardless of these proposals. We believe that the decision not to proceed this year with the other proposals, including those to restrict the scope of the MTC to individual clients and small enterprises will provide more scope for these issues to be considered.
- We have considered the issue of the cost to firms of 'additional' cover over the £500,000 and the likelihood of this being on different terms from the MTC. Our discussions have indicated that there is no reason to believe that a firm seeking renewal with its existing insurer and that wishes to continue to purchase cover up to the previous maximum will lose out as a result of this change. It is anticipated that insurers competing for a firm's business will offer cover based on the existing MTC, assuming it satisfies the insurers underwriting criteria. Reaction from the market will vary. However this will be the first time that insurers will be able to compete on coverage terms given the new limit,

and we will need to monitor the market and ensure the next stage of reforms takes into account any developments.

55. However, we do not consider that it would be appropriate for us to require the over-insurance of individual consumers, in order to ensure that small firms can attract large commercial consumers and, if it were thought to be appropriate, it would need to be very transparent.

56. We have also considered whether there is disproportionate involvement of small firms across the categories of conveyancing, probate and personal injury work where representations have focused on the need for additional cover. Data from the SRA's RF1 returns shows that 51% of sole practitioners and 70% of firms with 2-4 partners carry out at least some work in one or more of those areas, compared to 75% of firms with 5-25 partners and 88% of firms over 26 partners. Of course, some of these areas of work are unlikely to require cover beyond £500,000 - see our earlier comments at paragraph 27. It is possible that the proposed reforms may take some time to have an impact on premium, as the market takes time to respond.

57. We considered if there were likely to be any particular diversity impacts. We recognise that BME lawyers are over-represented among the smallest firms. These proposals are intended to reduce premiums for those firms which is a positive and of course any firm can take additional cover if it considers that to do otherwise would not help their business.

All open law practice head offices with a current recognition

	Does firm do conveyancing, probate, personal injury work?*				**All open law practices**	
	Yes		**No**			
Number of partners	**Number**	**%**	**Number**	**%**	**Number**	**%**
1	2,443	37%	2,379	59%	**4,822**	**46%**
2-4	2,970	45%	1,261	32%	**4,231**	**40%**
5-10	708	11%	232	6%	**940**	**9%**
11-25	238	4%	80	2%	**318**	**3%**
26-80	108	2%	15	0%	**123**	**1%**
81+	53	1%	7	0%	**60**	**1%**
no open partner posts	24	0%	28	1%	**52**	**0%**
Total	**6,544**	**100%**	**4,002**	**100%**	**10,546**	**100%**

* taken from approved RF1 applications from 2013-14

58. Evidence suggests that BME firms face greater difficulties in the insurance market than white firms as identified by historical evidence in the number of BME firms which entered the Assigned Risk Pool, when this scheme was available. BME firms are over represented among sole practitioners (21% of BME practitioners work in 1 partner firms and 24% in 2 – 4 partner firms[10])

[10] Regulatory Diversity Monitoring Report 2013

and are more likely to be involved in work areas, as the table above shows in conveyancing, probate, personal injury and immigration, where insurance has traditionally been difficult to obtain. The change in policy may make it easier for these firms to purchase PII.

59. There is a risk that, depending upon how the market develops in response to the proposed changes, some firms may need to provide more information in order to obtain the level of cover which they had benefit of under the previous minimum terms. This may incur time and cost. We have no information available however to suggest that if this does occur it would be more likely to occur in a BME firm. What does appear to be likely however is that smaller firms will have a greater range of options available to them in purchasing a level of cover appropriate to them. With that in mind we see small firms, and in turn BME firms, as being most likely to benefit from the proposals.

60. We also believe that proceeding with this proposal will help implement recommendation 20 of the Independent Comparative Case Review as set out in paragraph 1.6 of our initial response to the review[11]:

- Publish proposals to reduce the regulatory burden for small firms and to improve our engagement with, and regulation of, them.
- Pursue a programme of regulatory reform to ensure our regulation is more targeted and proportionate.

Increasing public understanding of the citizen's legal rights and duties

61. Increasing access to legal advice by those who are less well off within society is likely to promote this objective, to a marginal extent if lower cost products that require lower levels of insurance can be developed.

Promoting and maintaining adherence to the professional principles

62. By ensuring that the Code includes an obligation to ensure that appropriate insurance is in place having regard to factors such as potential levels of claim and the client base these proposals will promote and maintain adherence to the professional principles. We are confident that the vast majority of firms will buy appropriate cover.

F. STATEMENT IN RESPECT OF THE BETTER REGULATION PRINCIPLES

Proportionality

63. We have to balance the level of protection provided to solicitors' clients by compulsory professional indemnity insurance against the cost of providing that protection and its impact on the affordability of legal services. We consider that the proposed changes are proportionate as they should assist smaller firms to provide an appropriate level of protection to clients without the need to purchase unnecessary levels of cover. We have considered removing the requirement for minimum cover altogether, recognising that there is a case to be made for simply relying on the wider obligation to secure appropriate cover. We feel on balance that it is proportionate to retain a minimum

[11] http://www.sra.org.uk/documents/SRA/equality-diversity/independent-comparative-case-review-iccr-response-june-2014.pdf

requirement, although, if the proposals are approved, we will keep this under review.

64. We recognise that the extent to which solicitors achieve the Outcome will depend, in part, upon our supervision and enforcement arrangements. We will be taking proportionate steps to satisfy ourselves that firms have the appropriate level of cover. We will consider the level of insurance cover a new firm has in place as part of our risk assessment to determine the level of supervision the firm requires. Our supervision will be based on our assessment of the likelihood that firms might under-insure and by ongoing engagement with firms. For example:

- where firms have already been allocated to a named Supervisor or Regulatory Manager (**RM**) we will ask every Supervisor/RM as part of their routine or next engagement with an assigned firm to ask questions and seek evidence of compliance with the new Outcome;
- we will also ask the question (and seek evidence of compliance) of any firm with whom we are engaging on another matter - which will include a large number of non-assigned firms – so that we can also monitor the level of compliance with the Outcome for some low and medium risk firms; and
- we will consider performing an early, targeted, exercise to contact those firms with (say) more than 10% of their income derived from personal injury work, or those firms handling catastrophic personal injury claims, pointing out their responsibility to comply with the Outcome – as we did to the same cohort in relation to the ban on referral fees in personal injury cases.

65. We are conscious that the current regime, being a one size fits all requirement, does not provide the SRA with the information on which to base targeted regulation now that new requirement to have appropriate cover is being put in place. Therefore, over time we will learn and revise these activities to ensure that we target the right firms. Other changes to minimum terms will further change incentives and we will keep our supervision approach under consideration.

Accountability

66. The SRA is accountable to all its stakeholders in relation to client financial protection matters including: consumers; the profession; the participating insurers; BME groups. The SRA has to provide arrangements that are effective but sustainable. Ineffective or overly expensive client financial protection arrangements will impact on all these stakeholders, and the wider public interest. The SRA's approach to regulation is subject to intense political and professional scrutiny. These proposals have been subject to deep and meaningful scrutiny: during our consultation process; through our own internal governance arrangements; and now, as part of the LSB's oversight and approval process.

67. The SRA Board's recent policy statement "Approach to regulation and its reform" sets out a clear framework and rationale for a programme of reform.

Consistency

68. The new SRA Indemnity Insurance Rules are consistent with previous rules but are in the process of evolving in accordance with the SRA Board's recent policy statement. A wider review is being undertaken with a view to introducing further changes in October 2015.

Transparency

69. The changes to the Code, SIIR and the Glossary will be published on the SRA website as part of changes to the SRA Handbook 2011 to be introduced on 1 October 2014. Comparison software on the website will enable all the changes to be identified by means of comparisons with existing documents.

Targeted

70. The reduction in the minimum cover for any one claim coupled with the introduction of the new Outcome in the Code will provide more target protection for consumers of legal services as firms will be required to provide an appropriate level of protection to clients without the need to purchase unnecessary levels of cover.

G. STATEMENT IN RELATION TO DESIRED OUTCOMES

71. The changes with respect to client financial protection are being made in accordance with the programme of reform set out in the SRA Board's recent policy statement "Approach to regulation and its reform". This is the first stage of a wider review of our client financial protection arrangements which will be carried out over the next twelve months.

H. STATEMENT IN RELATION TO IMPACT ON OTHER APPROVED REGULATORS

72. We have not identified any adverse impact on people regulated by other approved regulators.

I. IMPLEMENTATION TIMETABLE

73. The annual compulsory professional indemnity insurance period runs from 1 October to 30 September each year, with the new rules coming into force on 1 October 2014.

74. As well as publicising the new rules on our website the participating insurers have to be informed in advance, usually in June, to enable them to adapt the wording of their policies which have to meet the requirements of the MTC. Participating insurers normally start to send out proposal forms in July and the profession start to return these completed in August.

75. The single renewal date was removed on 1 October 2013 but in excess of 10,000 firms have stuck with the 1 October renewal date. This means that huge numbers of proposal applications have to be completed and processed by participating insurers or their brokers in a very short time. There is an

urgent need for the approval process to be completed as quickly as possible to enable insurers to have certainty as the terms of the MTC in particular.

76. All the changes to the Code, the SIIR and the Glossary set out in the annexes to this application will come into force on 1 October 2014.

J. STAKEHOLDER ENGAGEMENT

77. These proposals are the latest in a succession of reforms aimed at ensuring that our compulsory professional indemnity requirements keep in step with the changes in the legal services market and strike the right balance between the level of protection provided to solicitors' clients and the cost of providing that protection and its impact on the affordability of legal services. The last fundamental review was carried out in 2010 which involved detailed consultation with stakeholders and resulted in the abolition of the Assigned Risks Pool, the introduction of the extended indemnity and cessation periods and the removal of the single renewal date.

78. The SRA carried out a full public consultation between 7 May 2014 and 18 June 2014 regarding five proposals relating to changes to our minimum compulsory professional indemnity cover. The consultation was published on our website in the usual way.

79. We have engaged with a wide range of stakeholders throughout the consultation period including the CML, insurers, the Association of British Insurers, the Law Society and the Consumer Panel. A total of 142 responses were received from a range of stakeholders including a very detailed response from the Law Society. A copy of the report on consultation responses and SRA conclusions is attached as **Annex 4**.

80. Many of the respondents provide detailed responses to the consultation document, with a clear indication of disagreement for the proposed changes. Others do see the proposals as positive. However, a key theme of dissent is criticism of the timing, the perceived haste and the lack of an impact assessment. Other common themes are the potential for disproportionate negative impacts on small firms and on lender panels, the risk of reduction to cover without lowering premiums, and the potential loss of clarity and client protection.

81. The Law Society is strongly opposed to the proposals in principle. It does accept that there are elements that will benefit from reform. However it feels that a rushed timetable for decision and implementation will lead to chaos in the market and significant damage to consumer protection. It states that the proposals require reconsideration and support by proper evidence and full impact assessments. Given the strength of the its opposition the Law Society's President, Chief Executive and Chair of the Regulatory Affairs Board were all invited to address the SRA Board for 30 minutes at the start of the SRA board meeting where decisions were to be made.

82. Those that supported the proposals came from a number of sectors. Some were individual practitioners. The Law Centres Federation felt that the proposals were an important part of a move to more proportionate regulation for ‘low risk’ providers and ensuring that any protection is focussed on the most vulnerable clients. QBE, the insurance provider with the largest market share for solicitors' PII, supported the proposals as a step towards a better

balance between consumer interests, the commercial interests of providers and the need for a vibrant insurers market.

83. We have listened carefully to the consultation responses. We remain concerned that the level of insurance premiums drives costs for firms in ways that may make it more difficult to compete. This is particularly the case for small firms – the Law Society's 2013-14 survey stated that 'the cost of premiums remains by far the most important factor in decisions about which insurer to use for nearly all firms. A higher proportion of sole practitioners gave cost as the most important factor in their decision'. The survey also confirmed that, although the differential had fallen, sole practitioners paid a higher percentage of their income in premiums than other firms.

84. High costs of regulation also restrict access for clients. There is a body of research that shows that clients struggle to access legal services – including small businesses and clients that are not eligible for legal aid and cannot afford a lawyer on their own account. A fair regulatory system needs to balance protection of those clients that can access services with extension of that access. A regulatory system that is designed so that no client ever loses out could operate at an unjustifiable and perhaps unsustainable cost.

85. The timing of the consultation was motivated by our desire to assist practitioners and insurers in negotiating less rigid terms and lower premiums for the 2014 renewal process, which for most firms will be in October. Although a common theme of those against the proposals has been that they will not reduce premiums, the advice we have obtained is that the reduction of the minimum limit per claim should reduce premiums by between 5 -15%.

86. It is difficult to estimate how many firms stand to gain from this reduction, or the extent to which reductions in costs in writing cover are then passed through into lower premiums and then lower costs for consumers. We do know that over 2,300 sole practitioners do not undertake any probate, conveyancing or personal injury. Further we know that the circa 2,400 that do undertake such work will often be handling transactions significantly below the proposed £500k minimum level of cover. PII represents a significant cost of running a firm with premiums for sole practitioners averaging just over £6,000 and for 2-4 partner firms in around £25,000[12].

87. We also considered if the reduction in the minimum level of cover may present a problem for firms that do wish to have additional 'top up' cover. Our insurance advisers confirmed that any firm currently taking £2m/£3m of cover on the current minimum terms could expect to continue to do so in future without any change in price.

88. In our consultation we stated that a final impact assessment would be prepared as part of the decision making process and invited applicants to submit data as part of their responses. We have also gathered data during the consultation period, and are confident from our assessment (see Annex 4) of the likely impacts that it is right to proceed with the following proposals for October 2014:

- the reduction of the level of compulsory cover per claim to £500,000;

[12] http://www.lawsociety.org.uk/representation/research-trends/research-publications/documents/PII-renewal-for-the-2013-14-indemnity-year-(full-report)/

- a new Outcome in the Code to assess and purchase an appropriate level of insurance cover.

89. The Consumer Panel has expressed concern at our proposed changes. They have not rejected them out of hand (and indeed supported the proposal to change the code and restrict claims to individuals and small enterprises) but have said they would need to see further evidence to be satisfied that costs and benefits were properly working to consumer benefit. In our view, the analysis referred to above and set out in Section E does just that.

K. FURTHER EXPLANATORY INFORMATION

Displacement to the Compensation Fund?

90. Compulsory PII covers all civil liability arising from private legal practice. The Compensation Fund provides discretionary grants for losses arising from dishonesty and failure to account (the latter also requiring evidence of hardship). It is not intended that the Compensation Fund becomes a top-up fund because of the limit on compulsory insurance cover.

91. There is however, some scope for claims that would previously have been dealt with fully by insurance being paid by insurers to the limit of £500,000 with the balance being sought from the Compensation Fund: because the claim is based on dishonesty (perhaps of one partner, in circumstances where the other partners are entitled to indemnity from their insurers) or on failure to account, bearing in mind that claims described as "negligence" are often actually based on breach of trust by the paying away of money inappropriately.

92. This will be mitigated if the parallel proposal to limit claimants to the Compensation Fund to individuals and small organisations is implemented. The Compensation Fund will also be alert to the potential manipulation of claims to fit them within its criteria. There is the potential however, for some impact on grants made and reduced saving on resource because of the need to deal with the applications.

93. Similarly, clients of firms that have not obtained insurance can apply to the Compensation Fund for a (discretionary) grant on a basis analogous to "all civil liability". In drawing up final rules for the changes to Compensation Fund eligibility, it will be important to ensure that such cases are treated similarly to PII claims: "civil liability" losses will be subject to a limit of £500,000 and above that the Compensation Fund's core criteria will apply. It will also be important to ensure that the absence of insurance cover above the compulsory limit (in breach of the new obligation to assess and purchase appropriate cover) is not the same as failure to obtain compulsory cover and so brought within the Compensation Fund's ability to pay on the wider basis.

Next stage

94. One of the difficulties in producing evidence for change is the lack of profession wide professional indemnity claims data other than data from SIF dating back to the 1990s. We have sought to overcome this problem by

applying claims patterns from SIF data to up to date data. The Law Society is opposed to the reduction in the level of cover as a matter of principle so no amount of up to date data is likely to affect their position.

95. Several stakeholders have highlighted the problems with the current compulsory PII arrangements and some have called it a "broken market". Further work to reform the arrangements is urgently required. In July 2014 we will launch a call for evidence in relation to the PII Market. This call for evidence will include the proposals from the recent consultation that we are not proceeding with at this stage; a particular focus on the minimum terms as set out in paragraph 6 above; run off cover as set out at paragraph 7 and any other areas that respondents consider relevant. Because of the relationship between PII and the Compensation Fund we will also seek evidence on potential reform to the Compensation Fund.

96. By the end of 2014, we will issue a consultation paper inviting further views in relation to the delayed proposals and other proposals for changes to the MTC and also the Compensation Fund. We currently intend to announce the results of this consultation in April 2015, with implementation of changes from 1 October 2015, although some proposals may benefit from a longer lead in time to implementation. We expect questions about the handling of client money to be a feature of the call for evidence and consultation. This current application therefore sits in the middle between earlier and later reforms.

97. If the changes proposed in this application are approved, we will pay close and careful attention to their impacts. We are aware that the impacts cannot easily be measured in isolation from other factors, so a movement - or no movement - in premium prices is unlikely to be directly attributable to these reforms. But there will be other ways in which we can assess impacts, for example by monitoring the number of uninsured claims that arise over the next couple of years.

ANNEXES

Annex 1: SRA Indemnity Insurance Rules 2014

Annex 2: SRA Indemnity Insurance Rules 2014 showing all changes as compared to the SRA Indemnity Insurance Rules 2013

Annex 3: SRA Amendments to Regulatory Arrangements (Miscellaneous No.1) Rules 2014

Annex 4: Report on consultation responses and SRA conclusions

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