

Application made by the Solicitors Regulation Authority Board to the Legal Services Board under Part 3 of Schedule 4 to the Legal Services Act 2007, for the approval of changes to regulatory arrangements relating to the Compensation Fund through introduction of eligibility criteria

A. Summary

1. This application is made by the Solicitors Regulation Authority (SRA) to the Legal Services Board (LSB) for approval of changes to the SRA's regulatory arrangements, to give effect to eligibility criteria setting out those applicants that may be able to apply for a grant out of the SRA's Compensation Fund.
2. Persons will be eligible to apply for a grant out of the fund where the person is an individual, or at the time the application is made, is a sole trader, partnership, body corporate, unincorporated association or mutual association with an annual turnover of less than £2 million.
3. Charities and trusts with an income or net asset value of less than £2 million, will be eligible to apply for a grant but in cases where there has been a failure to account will have to satisfy the SRA that its beneficiaries have suffered, or are likely to suffer, hardship if a grant is not made.
4. In cases where charities and trusts have an income or net asset value of more than £2 million, and have suffered loss as a result of dishonesty or a failure to account, they will have to satisfy the SRA that its beneficiaries have suffered, or are likely to suffer, hardship if a grant is not made.

B. Details of the SRA's current regulatory arrangements

5. The purpose of the SRA's compensation arrangements review is to identify alternative ways of delivering the optimum level of client protection. We have considered the current arrangements and what proportionate and targeted arrangements might look like, not only as a means of protecting the consumers of legal services, but also from the perspective of the broader public interest. Through its compensation arrangements, the SRA needs to ensure that the public is protected from harm, including that caused by dishonesty, incompetence or unethical behaviour.
6. The Compensation Fund provides a safety net for those affected by authorised individuals or firms who have misappropriated, or failed to account for, money in the course of practice. The Compensation Fund has always been considered as a fund of last resort and therefore, grants should not be made where the applicant is otherwise indemnified against loss. The Fund can also make grants in respect of the civil liability of the defaulting practitioner where the authorised individual/firm has failed to take out qualifying insurance.
7. At present there is no restriction on who can apply for and be paid a grant out of the Fund. Anyone can make an application free of charge and does not have to be a client of the closed firm. A claim can be made by an individual consumer,

company, charity or other entity and irrespective of the wealth and means of the applicant.

8. An applicant who can show that he or she has suffered loss as a result of failure to account for money is deemed to have suffered hardship if he or she is an individual whose dealings with the defaulting practitioner have been in a personal capacity. If the applicant's dealings with the defaulting practitioner have been in a business capacity then they must provide evidence to show that the body or individual has suffered or is likely to suffer hardship.
9. If the applicant has suffered loss because of the defaulting practitioner's dishonesty there is no 'hardship test' to satisfy.
10. There are clear advantages to clients and consumers in being able to claim from a Compensation Fund for financial loss arising from misuse or misappropriation of client money. However, entities regulated by the SRA serve a wide range of clients, from individual consumers to large financial institutions and government agencies. These consumers are not all empowered to the same extent in their choice of service provider. Nor do they possess the same amount of knowledge and confidence to engage with a firm to put things right if they are unhappy with an aspect of the service received. Some are more able to protect themselves than others, for example by insuring themselves against such losses, or demanding that solicitors take additional steps to protect client money, for example by holding it in an escrow account. Large commercial service users are better able to protect their interests and make a commercial decision on the use of legal services and the risks involved.
11. In practice few large corporate consumers are in fact paid out from the Compensation Fund. This tends to be because they have other avenues of redress available or have contributed to their loss. Even where a claim is rejected, there are substantial costs involved for both parties in making and deciding the claim. Many large claims are complex and ascertaining and analysing the facts can be time consuming. The SRA's costs in doing this are borne by the Compensation Fund.

C. Nature and effect of the proposed alterations to the SRA's regulatory arrangements

12. The consultation set out proposed eligibility criteria, limiting all applications to the SRA's Compensation Fund to:
 - individuals;
 - micro-enterprises – businesses with a turnover not exceeding £2 million;
 - charities with annual income of less than £2 million; and
 - trustees of a trust with a net asset value less than £2 million.
13. An amendment to the SRA Handbook glossary definition of '*Applicant*' was proposed, to give effect to the criteria.
14. Taking into account feedback from the consultation exercise, it was considered appropriate for the criteria to be set out in the body of the SRA Compensation Fund Rules 2011 so that applicants could easily access the criteria. It was also suggested that the position with regards to charities and trusts be considered further.

15. The SRA Amendments to Regulatory Arrangements (Compensation Fund Eligibility) Rules [2014], which are set out in **Annex 1**, were made by the SRA Board on 17 September 2014, subject to approval by the Legal Services Board. The rule changes are intended to facilitate implementation of the eligibility criteria and the impact of changes are set out in the table of eligibility (**Annex 2**).
16. Persons will be eligible to apply for a grant out of the Fund where the person is an individual, or at the time the application is made, is a sole trader, partnership, body corporate, unincorporated association or mutual association with an annual turnover of less than £2 million.
17. Charities and trusts with an income or net asset value of less than £2 million, will be eligible to apply for a grant but in cases where there has been a failure to account will have to satisfy the SRA that its beneficiaries have suffered, or are likely to suffer, hardship if a grant is not made.
18. In cases where charities and trusts have an income or net asset value of more than £2 million, and have suffered loss as a result of either dishonesty or a failure to account, they will have to satisfy the SRA that its beneficiaries have suffered, or are likely to suffer, hardship if a grant is not made.
19. We have taken the opportunity to simplify the criteria where possible and set out who will be eligible to apply for a grant out of the Fund. We have also confirmed that the criteria will apply at the time an applicant makes a claim to the Fund and that we will have the discretion to adopt a method to determine eligibility and to make a broad estimate of any relevant amount. This is intended to avoid technical or disproportionate arguments about the eligibility requirements and will allow the SRA to determine and make an estimate of the financial amounts in relation to eligibility of applicants. We consider this to be an appropriate approach given the nature of the Fund and have noted that a similar approach was adopted in determining eligibility to make a complaint to the Legal Ombudsman. This rule amendment is set out in Rule 3.11 of **Annex 1**.
20. A definition of turnover has been introduced in the SRA Handbook Glossary 2012 with reference to terminology used in Companies Act 2006. 'Turnover' has been defined the amounts derived from the provision of goods and services in the most recent financial year, after deduction of:
 - a) trade discounts,
 - b) value added tax, and
 - c) any other taxes based on the amounts so derived.

This definition has been drafted with reference to section 474(1) of the Companies Act 2006 as this definition is understood to be used for accounting purposes.
21. Charities and trusts will continue to be eligible to make claims on the Compensation Fund however, the 'hardship test' will apply more widely to charities and trusts with an income or net asset value of more than £2 million, than to other claimants, that is by applying the test to all claims, including dishonesty. This has been set out in the Rules 3.9 and 3.10 of **Annex 1**.
22. A new Rule 3.12 has been introduced to reflect that applications which fall outside the remit of the Fund will be determined summarily. It is envisaged that this will save time, cost and resource in the investigation of an application.

D. Rationale for amendment

23. Our research into why the Compensation Fund was established supports the concept that the Fund should predominantly provide for private individuals and small businesses as they had the lowest levels of experience and expertise in dealing with legal services providers. These consumers are also least able to bear a financial loss if a firm could not replenish funds that had been misappropriated. The rationale for our changing approach to regulation is the need to focus on consumers that need regulatory protection.
24. Section 36 (2) of the Solicitors Act 1974 makes provision for rules to be made which set out the circumstances in which grants may and may not be made from the Fund. The SRA must have regard to the differing degrees of experience and expertise of consumers when securing the appropriate degree of protection for them. Information collected (and published on the SRA's website) about the purpose of the SRA's Compensation Fund and the comparative of other jurisdictions highlights that, in this context, that compensation cover should principally be directed toward those consumers who are least able to sustain a financial loss.
25. Some consumers have the resource to be able to protect themselves. These consumers are more likely to be repeat purchasers, more likely to employ lawyers themselves, have purchasing and procurement power and expertise and are better able to manage loss. These consumers are therefore, able to put a solicitor's claims of expertise and status under shaper scrutiny. Given the differential capacities of consumers to protect themselves, the SRA considers it appropriate to limit claims made to the Compensation Fund.
26. In developing our proposals we have considered scheme rules adopted by the Legal Ombudsman and also criteria implemented by the Financial Conduct Authority in their management of the Financial Services Compensation Scheme. Both schemes have restricted their protection to individuals and small entities. Given the differential capacities of consumers to protect themselves, we have concluded that we should make the change in order to focus the fund on those who require regulatory support.
27. The eligibility criteria will therefore provide a framework for how we will manage claims made to the Compensation Fund and will inform good practice and robust decision making in the long term.

E Statement in respect of the Regulatory Objectives

28. The SRA must, so far as is reasonably practicable, act in a way that is compatible with the regulatory objectives set out in the Legal Services Act 2007, and in a way that it considers to be most appropriate for the purpose of meeting those objectives.

Protecting and promoting the public interest

29. Confidence in the legal system supports the delivery of this objective. Consumer confidence in the legal services market is underpinned by an expectation that client money will be safeguarded. This protection is primarily delivered through an obligation to comply with the SRA's Accounts Rules 2011, which set out detailed requirements for the handling of client money. The Compensation Fund

provides an additional "safety net", but does not apply in all circumstances, for example if a client has contributed to their loss or has other avenues for redress. We do not consider that the eligibility criteria will impact adversely upon individual consumers and some very small businesses, charities and trusts and it is therefore, unlikely that consumer confidence in its broadest sense will be impacted.

Protecting and promoting the interests of consumers

30. We consider that the eligibility criteria will ensure that the interests of those consumers who need support through our regulatory arrangements are adequately protected. Consumers of legal services are entitled to expect a good quality service from those providers they instruct, and they should be able to have confidence that if something does go wrong that there is in place a source of financial redress. The aim of the criteria is to provide those consumers needing support with the assurance and confidence that client financial protection arrangements remain in place.

Supporting the constitutional principle of the rule of law

31. The proposals will have a neutral impact on the constitutional principle of the rule of law.

Promoting competition in the provision of services

32. It is anticipated that the criteria will promote competition in the provision of legal services in that providers of legal services will look to effective and efficient ways of marketing their businesses and holding client money. Firms advising a consumer will be under an obligation to provide information to their client about the regulation of legal services and what protections are available to them.

Improving access to justice

33. The proposals will have a neutral impact on access to justice in respect of individual consumers or very small businesses, charities and trusts. Although the proposals have the effect of removing the "safety net" for larger businesses, it is considered that this is unlikely to have an adverse impact on access to justice for these clients, as they are better able to protect their positions in other ways, for example by insuring themselves against loss. Providers will have the opportunity to innovate and develop new approaches to meeting and satisfying the requirements of their commercial clients.

Encouraging an independent, strong, diverse and effective legal profession

34. It has been suggested that a consequence of the eligibility criteria will be that lenders, who may be seeking to reduce panel sizes, will be less inclined to appoint small firms to their panels. If this were true it would be likely to have a disproportionate impact on BME solicitors who are over-represented within small firms. However, given that most claims by large clients are not met, it is difficult to envisage that the proposals will have material impact on the composition of lenders' panels. We do not consider that implementation of the criteria will have a negative effect on the most vulnerable consumers.

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

35. The amendments are considered to have a neutral effect on this regulatory objective.

Promoting and maintaining adherence to the professional principles

36. The amendments are considered to have a neutral effect on this regulatory objective.

F. Statement in respect of the Better Regulation Principles

37. The SRA considers that the proposed alterations fulfil our obligation under section 28 of the Legal Services Act to have regard to the Better Regulation Principles. It is expected that the proposed changes to the eligibility criteria for claiming on the Compensation Fund will lead to more proportionate and targeted regulation as it ensures that those in greater need are adequately protected by the Fund.
38. The proposed change will ensure an efficient and effective use of SRA resource as the overall number of claims made should fall.
39. We have consulted publicly on the proposed changes and taken account of the views of stakeholders in developing our approach. We will be publishing guidance for applicants and will continue to update information. The SRA is accountable to all its stakeholders in relation to client financial protection arrangements including: consumers; the profession; insurers and BME groups. The SRA has to provide arrangements that are effective and sustainable. Ineffective 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 scrutiny. These proposals have been subject of discussion during our consultation process; through our own internal governance arrangements; and now, as part of the LSB's oversight and approval process.

G. Statement in relation to desired outcomes

40. The SRA continues to ensure that it has in place a regulatory framework which is proportionate and targeted and contains only those regulations and processes that benefit the public interest. The chief impact of the misuse and misappropriation of client money is upon those persons whose money has been misused, although such activities will also harm public confidence in the legal market and solicitors. This can crystallise as an actual loss of money, requiring remedy from the Compensation Fund. Given the differential capacities of consumers to protect themselves, we consider that eligibility criteria will allow us to manage the Compensation Fund in a way which results in ensuring that individuals, small businesses, charities and trusts are protected.
41. The eligibility criteria will therefore provide a framework for how we will manage claims on the Fund and will inform good practice in the long term. The criteria will underpin our decisions and our process. We will assess the effectiveness of the criteria as we continue to reform our approach to regulation and focus on the areas of greatest risk and on those issues that matter the most.

H. Stakeholder engagement

42. We have engaged extensively with a wide range of stakeholders and will continue to take up opportunities to attend meetings and speak at events. Subject to LSB approval, the rules will come into effect on 1 April 2015 and the criteria will apply to all claims received from that date. Prior to 1 April 2015, details of criteria will be communicated and set out on the SRA website so that stakeholders are aware of the criteria and its impact.
43. Guidance for applicants is being finalised which will be made available on the SRA website, Legal Choices and circulated to consumer groups and forums. The guidance will enable potential applicants to decide whether they are eligible to make a claim and the information that they may be required to provide when submitting a claim. In addition, we will continue to engage further on the review of the SRA's compensation arrangements.

I. Statement in relation to impact on other Approved Regulators

44. We do not believe our proposals give rise to any conflict between any of the approved regulators.

J. Implementation timetable

45.

25 September 2014	Application to the LSB for approval of the SRA Amendments to Regulatory Arrangements (Compensation Fund Eligibility) Rules [2014]
November 2014 - March 2015	Publication of the eligibility criteria on the SRA website and engagement with consumer groups and other key stakeholders
1 April 2015	Proposed change implemented in Version 13 of the SRA Handbook

K. SRA contact for matters relating to this application

40. If the Board have any queries in relation to this application please contact:

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- Annex 1** SRA Amendments to Regulatory Arrangements (Compensation Fund Eligibility) Rules [2014]
- Annex 2** Table of eligibility
- Annex 3** SRA Board paper - SRA Compensation Fund - introduction of eligibility criteria, 17 September 2014 (attached separately)

SRA Amendments to Regulatory Arrangements (Compensation Fund Eligibility) Rules [2014]

Preamble

Rules dated [date of approval by LSB] made by the Solicitors Regulation Authority Board under sections 36, 36A, 79 and 80 of the Solicitors Act 1974, section 9 of the Administration of Justice Act 1985, section 83(5)(e) of, and paragraph 19 of Schedule 11 to, the Legal Services Act 2007, and the relevant provisions of an Order made under section 69 of the Legal Services Act 2007, SI No 2011/1716, with the approval of the Legal Services Board under paragraph 19 of Schedule 4 to the Legal Services Act 2007.

Rule 1

The SRA Compensation Fund Rules 2011 shall be amended as follows:

(a) replace rule 3.4 with:

“3.4 For any grant to be made out of the Fund, an *applicant* must satisfy the SRA that the *applicant* is eligible in accordance with rule 3.7, 3.8, 3.9 or 3.10 and (save in respect of a grant made under rule 5) that:

(a) he has suffered or is likely to suffer loss in consequence of the dishonesty of a *defaulting practitioner* or the *employee* or *manager* or *owner* of a *defaulting practitioner*, or

(b) he has suffered or is likely to suffer loss and hardship in consequence of a failure to account for money which has come into the hands of a *defaulting practitioner* or the *employee* or *manager* or *owner* of a *defaulting practitioner*, which may include the failure by a *defaulting practitioner* to complete work for which he was paid;

in the course of an activity of a kind which is part of the usual business of a *defaulting practitioner* and, in the case of a *defaulting licensed body*, the act or default arose in the course of performance of a *regulated activity*.”

(b) insert rules 3.7 to 3.12 as follows:

“3.7 A *person* is eligible under this rule to apply for a grant out of the Fund where the *person*:

(a) is an individual; or

(b) at the time the application is made, is a sole trader, *partnership*, *body corporate*, unincorporated association or mutual association with an annual *turnover* of less than £2 million;

and does not fall within rule 3.8, 3.9(a) or 3.10(a).

3.8 A *person* is eligible under this rule to apply for a grant in the circumstances set out in rule 3.4(a) if at the time the application is made the *person* falls within one or more of the following categories:

- (a) a *charity* with annual income net of tax in the most recent financial year of less than £2 million; or
- (b) a *trustee* of a trust with an asset value of less than £2 million.

3.9 A *person* is eligible under this rule to apply for a grant in the circumstances set out in rule 3.4(b) if the *person*:

- (a) at the time the application is made falls within one or more of the following categories:
 - (i) a *charity* with annual income net of tax in the most recent financial year of less than £2 million; or
 - (ii) a *trustee* of a trust with an asset value of less than £2 million;

and

- (b) has satisfied the SRA that its beneficiaries have suffered, or are likely to suffer, hardship if a grant is not made.

3.10 A *person* is eligible under this rule to apply for a grant in the circumstances set out in rule 3.4(a) or (b) if the *person*:

- (a) at the time the application is made falls within one or more of the following categories:
 - (i) a *charity* with annual income net of tax in the most recent financial year of £2 million or more; or
 - (ii) a *trustee* of a trust with an asset value of £2 million or more;

and

- (b) has satisfied the SRA that its beneficiaries have suffered, or are likely to suffer, hardship if a grant is not made.

3.11 Having regard to the discretionary nature of the Fund, the SRA may take into account such evidence as it sees fit when determining eligibility under rules 3.7 to 3.10 and may make a broad estimate of any relevant amount.

- 3.12 The *SRA* may summarily determine whether a *person* is eligible to apply for a grant.”

Rule 2

The *SRA Handbook Glossary 2012* shall be amended as follows:

- (a) after the definition of “**trustee**” insert:

“turnover

in the *SRA Compensation Fund Rules* means the amounts derived from the provision of goods and services in the most recent financial year, after deduction of:

- (a) trade discounts,
- (b) value added tax, and
- (c) any other taxes based on the amounts so derived.”

Rule 3

These amendment rules shall come into force on 1 April 2015.

SRA Compensation Fund - Table of eligibility

Claimant Type	Application basis (Dishonesty, Failure to account and hardship)	Requirement	SRA Compensation Fund Rules 2011
Individual	Dishonesty	Need not show hardship	3.4(a)
Individual	Failure to account & hardship	Hardship presumed under Rules	3.5(a)
Businesses with a turnover not exceeding £2 million;	Dishonesty	Need not show hardship	3.4(a)
Businesses with a turnover not exceeding £2 million;	Failure to account & hardship	Generally unable to show hardship unless for example, a small family business	3.5(b)
Businesses with a turnover exceeding £2 million	Both categories of claim	Excluded	3.7
Charity - with annual income of less than £2 million Trust - with a net asset value of less than £2 million	Dishonesty	Need not show hardship	3.8

Charity - with annual income of less than £2 million Trust - with a net asset value of less than £2 million	Failure to account & hardship	Need to demonstrate that beneficiaries have suffered, or are likely to suffer, hardship	3.9
Charity - with annual income of more than £2 million Trust - with a net asset value more than £2 million	Both categories of claim	Need to demonstrate that beneficiaries have suffered, or are likely to suffer, hardship	3.10