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Mr Chris Kenny
Chief Executive Officer
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By e-mail only

5 September, 2014

Dear Chris

Thank you for your recent letter enclosing a copy of the formal warning notice served on the Law Society in respect of the SRA's PII rule change application. You have asked us to provide you with further information about the specific concerns set out in your letter.

In your assessment of the SRA in February 2013 you said that *'The revised handbook is a step forward but it continues to include a large number of rules without clear evidence to justify the restrictions they impose and thus their retention.'*[1] Our application is an important element of our response to that criticism.

Before I address your concerns in detail, I would like to make some general observations which I hope will be helpful to your consideration of our application.

1. You have suggested that our proposal could be argued to be prejudicial (only) to the regulatory objective of protecting and promoting the interests of consumers. We find it hard to understand how this can be the case, unless you have interpreted the interests of consumers in its narrowest sense, that is securing financial protection and indeed the narrower sense of compulsory minimum insurance cover (even where that is strengthened by a properly contextual and flexible outcome). We believe the test you have to apply requires consideration of all the regulatory objectives and in the context of that relating to consumer protection also requires a broad analysis which includes considerations of access and value. We believe that our proposals strike the balance between securing proportionate financial protection, but at a price which does not negatively impact on access and value. We have, in our recent policy statement[2], made clear our regulatory approach recognises that all consumers do not require the same level of protection, or possibly any *compulsory* protection at all. In our view this is consistent with LSB analysis of the regulatory objectives.

[1] http://www.legalservicesboard.org.uk/Projects/pdf/20130226_regulatory_standards_SRA_final.pdf
[2] http://www.sra.org.uk/sra/policy/regulation-reform.page

2. In making the proposals we have taken into account the LSB's policy and statutory guidance. In your paper on the regulatory objectives[3] (Para 38 under promoting competition) you say that:

   "We will work with approved regulators to ensure that no element of regulation acts as a barrier to entry (or indeed exit from) the legal services market unless it is justified in the light of all the regulatory objectives. We will challenge approved regulators to find other ways of managing risks (such as duties on regulated firms or consumer education) so as to eliminate as many barriers and restrictions as is compatible with the regulatory objectives."

   We believe that the proposals are consistent with such an approach because the primary objective in changing our regulatory arrangements is to move from an arbitrary level of protection, which in many cases is unnecessarily burdensome, to one which is both targeted and proportionate. It is clear that no single level of cover can be appropriate for all transactions in a market as diverse as the one that we regulate. Many small firms offer services such as consumer or immigration advice where the potential loss recoverable by damages is far below even £500,000. Forcing them to obtain compulsory cover for £2m or £3m is to impose a significant and disproportionate barrier to them and to the consumers who need such advice.

3. You have suggested that the LSB may wish to refuse only the part of the application that relates to the proposed minimum level of cover of £500k. We would like to make clear that we see the proposal as one change achieved by a combination of alterations to rules, and while we do not doubt your vires for approval in part, we think it unlikely that it could be justified in these circumstances. In particular we would suggest that the effects of implementing only the new outcome while refusing the new minimum level have not been properly explored, assessed against the regulatory objectives or consulted upon. It would in fact increase burdens on some law firms without offering commensurate opportunities to reduce costs by allowing firms to put in place, where appropriate, a lower level of cover. It would be an increase in regulation but without necessarily improving consumer protection and would inevitably push costs up for some firms, without the benefits of potentially lower cover that would apply to others.

   We have also considered if we could operate a version of our approach with just the outcome in place. Specifically, we asked ourselves if we could use a waiver approach for firms that after applying the outcome could justify a lower level of cover. In our view the insurance market would be unlikely to become as flexible as is necessary in response to such an opportunity and thus firms may find it harder to get cover that they have assessed as appropriate for their needs. Even if that view is incorrect, we do not consider it feasible to operate a wide scale waiver approach to implement such a change.

[3] http://www.legalservicesboard.org.uk/news_publications/publications/pdf/regulatory_objectives.pdf

Furthermore, the LSB has repeatedly reminded us that '*a rule that is regularly waived is unlikely to be proportionate*'[4].

We would ask that you do not approve the application in part.

Turning to your specific concerns:

Evidence

The current level of cover is an arbitrary, generic level set several years ago with an un-evidenced distinction between partnership and limited liability law firms. It has been overtaken by developments in the current legal market and there is no convincing evidence that it is appropriate.

Your guidance to licensing authorities[5] says that '*ABS should be subject to the same consumer protection requirements as non-ABS firms. These should set minimum requirements for an appropriate level of consumer protection that reflect the risk posed by the activity (or activities) or type of client of the ABS. A tiered approach to the level of cover required is acceptable. ABS must have the flexibility to increase the level of indemnity as they see fit. The LA's indemnification requirements must be sufficiently flexible to allow other products and approaches to develop to meet changing market conditions.*'

In our view it is inappropriate to attempt to make an assessment of a single level of cover for an increasingly diverse market. We could never gather the level of evidence that would be necessary to set the level of cover from the centre - the level of evidence necessary would inevitably lead to a conclusion that a single level was not appropriate for such a plural legal market. George Yarrow, in his submission to the Government's 2013 call for evidence on reform of legal regulation makes the point that *'centrally planned economic systems can't cope with economic complexity, but decentralised systems can.'*[6] It is this that leads us to rely upon the outcome as the core driver of securing an appropriate level of cover for each firm.

Our objective in having any level of minimum cover is one of consumer and public confidence, as well as supporting smaller firms to work with the new outcome and duty. In our view the minimum level of compulsory cover (which is clearly a minimum in our proposals as combined with the outcome replaces the arguably arbitrary aggregate level currently in force) should be set at the lowest level that secures protection for most consumers in most circumstances. That is a balancing and proportionality exercise based on available information: it is a judgment call by our Board.

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[4] http://www.legalservicesboard.org.uk/about_us/board_meetings/pdf/Paper_13_11_SRA_performance_Anx_A.pdf

[5] http://www.legalservicesboard.org.uk/what_we_do/consultations/closed/pdf/abs_guidance_on_licensing_rules_guidance.pdf

[6] http://www.rpieurope.org/Publications/2013/RPI_response_to_MoJ_review_legal_services_regulation_GY.pdf

The evidence for choosing £500k is of course incomplete. £500k is a compromise between available evidence, regulatory and economic thinking and good regulatory practice. It is of course influenced by your statutory guidance and other commentary. The evidence for £500k is set out in our application. We note your suggestion of a survey but do not consider that likely to be helpful. We asked a specific question in the consultation: *'Are there any impacts, available data or evidence that we should consider in finalising our impact assessment?*' and did not receive any substantive *raw* evidence from insurers, lenders, professional bodies or others.

In our view there is no evidence to support the current minimum requirement of £2m/£3m. Our assessment of claims shows that it is too high for many firms and thus leads to higher levels of cover than is necessary. That this drives up premiums is shown succinctly and beyond doubt in one response to consultation. A firm that simply incorporated (thus triggering the change in required cover from a minimum of £2m to £3m) saw an increase in its PII premium even though the work, consumers and risk remained the same in all other respects.

In your letter to me of the 10 June 2014, on the specific issue of this consultation, you welcomed our *'clear intention, set out in the policy statement, to accelerate the reform of the SRA's approach to regulation, in particular the statement that the 'SRA will take the approach that the continuation of any existing regulatory intervention needs to be justified, rather than one of focusing on justifying its removal."* That does, as you know, echo the LSB's own position: in the LSB paper on the regulatory objectives referred to above you say '*It is for those who seek to maintain restrictions to justify them rather than for those that argue for their removal to justify change.*' That was in 2011 and indeed properly states the LSB's obligation in the current process. There is no suggestion in the legislation that the burden is higher for changing a regulatory arrangement than it is for introducing a new one. Were that to be the case, not only would it not fit with the consistent guidance from the LSB, but it would create the perverse situation where it is easier to introduce new burdens than it is to remove ones that are long standing and unjustifiable.

In 2013 in your press release announcing your submission to the Government's call for evidence on reforming regulation you said '*The LSB has therefore drafted a blueprint for incremental, but significant change. Specifically is proposes immediate action by the LSB and existing regulators to target regulation at identified risks, rolling back rules where this justification does not exist*.' We have set great store by these comments and it will be important for us to understand whether the LSB's position has now changed.

Cost savings

We received clear statements from some insurers that they would expect to see prices fall, and our expert advisers gave us clear advice on costs of cover at the revised minimum level as well as for top up cover, including on the basis of the minimum terms and conditions (MTC).

Furthermore, in the period between our application and your warning notice, we saw some market activity that supported our expectations. For example, Chancery PII (which focuses on firms with 1-4 partners – the very firms we expect to benefit from our proposals) was advertising cover at below £2m at reduced prices and continuing cover at £2m/£3m at the MTC for those firms that wanted it. In fact, Chancery PII confirms this even now, saying:

> '…*we were able to offer a solution (with a reduced premium) for firms who wished to purchase a lower limit as well as an offer for those who wished to maintain coverage up to the expiry minimum terms and conditions.*'[7]

In our view this answers your concerns squarely. Even before your decision has been made the PII market has adjusted and shown signs of innovation as the insurance market responded to the potential of greater freedom and the removal of barriers. We expect that this would intensify if the LSB approves the change and will further develop as we reform other aspects of the MTC.

But in any event, it would be odd to conclude that a reduction in cover would not affect prices and we are surprised that evidence of lower prices is required before a change can happen. In your Blueprint document, in the very first paragraph, the LSB says:

> *'Another justification for independent regulation of legal services is to prevent any anti-competitive professional restrictions or practices. Historically these have included fixed or minimum prices, and restrictions on organisational form or advertising. These types of practices lead to higher prices and less choice for consumers.'*[8]

In this case there is evidence in the form of consultation responses (including from the largest insurer by value), expert advice (from a retained broker with global expertise and experience) and immediate market response. That evidence specifically covers top up cover. It is hard to see what further evidence might be available before a change takes place that would be likely to alter our judgment.

The issue of top-up cover exists whenever there is a minimum level, regardless of whether it is set at £500k, £2m or higher. The Law Society annual survey shows that the purchase of top cover varies significantly by size of firm. In the latest annual survey 93% of firms with 11-25 partners invested in additional layers of cover whereas just 8% of sole practitioners did so. This does not suggest that there is a particular problem with the purchase of top-up cover, especially given that for small firms price is the single biggest factor in the PII purchase decision. The consultation responses provided no evidence to support a suggestion that top-up cover might become more expensive, and nor did our expert advice.

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[7] http://www.chancerypii.co.uk/~/media/Files/Articles/C03001%20Latest%20update%20from%20Chancery%20Pii%20201408.ashx

[8] http://www.legalservicesboard.org.uk/what_we_do/responses_to_consultations/pdf/a_blueprint_for_reforming_legal_services_regulation_lsb_09092013.pdf

Compensation fund

In our view there is little to add to our consultation, decision document and application to the LSB. In reaching its decision our Board carefully considered the links to the Compensation Fund, which were in our view properly explained in the papers. There is the potential for some additional claims to the Fund, though we do not consider these to be significant. The key, as with other aspects of the application, is to see the outcome and the new minimum cover requirement in conjunction: if firms adhere to the outcome then consumers will be better protected. That some firms undoubtedly will not comply is self-evident – some currently do not obtain indemnity insurance - and they will be tackled through a combination of firm level and thematic supervision, enforcement and a clear credible deterrent affect that follows strong enforcement. The Compensation Fund provides a fall back discretionary protection for certain cases and this has been fully considered in reaching our decision.

As you are aware, we are looking further at the wider financial protection regime following the call for evidence. This is also affected by the developing legal market with solicitors working in increasingly diverse forms and firms and as we reform the overall regulatory approach the financial protection regime will need to be modernised alongside it. There should be no concern about subsequent reductions in consumer protection at this point because they would be distinct proposals subject to consultation and of course separate applications to the LSB.

Consistency

We do not argue that because £500k is an appropriate minimum requirement for one regulator it must be so for another. Indeed, we are very conscious that, as you said in your assessment of the SRA in February 2013 '*Compared to other regulators, [the SRA] regulates markets that are more complex, markets that pose greater risks to the regulatory objectives and markets where consumers are more likely to be vulnerable.*' We recognise that we are regulating, alongside the BSB, the widest set of reserved activities.

The LSB must be consistent in how it applies its rules and process and in particular on the evidential basis it requires for any particular rule approval application. We have considered the wide range of designation and rule approval applications that touch upon PII and we can see very little by way of evidence to support the level of cover set out in those applications that matches what we have for this current application (although of course you may have seen more).

In our view it is right that you ensure that regulators are confident that they have the evidence to support their applications. But it is our Board that needs to be convinced on the evidence rather than yours. The LSB is only entitled to refuse an application if *satisfied* that certain limited grounds *exist*. The statutory framework does not permit that you refuse our application if you simply do not agree with our decision or do not

agree with the conclusions that we draw from the available evidence. The onus is clearly upon the LSB (as is clear in your warning notice) to consider if you have the evidence to conclude that our application is prejudicial to the regulatory objectives rather than to conclude that you are not convinced by our evidence or analysis, or that you would not have made the same decision in balancing costs and protections. Your warning notice only mentions one of the objectives, rather than the balancing of them all that is clearly required.

In the summary grounds of defence served by the LSB in the recent QASA judicial review the LSB itself said: *'The legislation thus makes clear that the role of the [LSB] is not to "second guess" the assessments made by the applicant regulators. If the [LSB] is to refuse an application (in whole or in part), the burden falls upon it to satisfy itself of overall prejudice to the regulatory objectives...*' We agree.

The presumption is that the application should be granted unless prejudice is established. Judgment about proportionality, under the scheme of the legislation, is one to be made in the first instance by the regulator which makes the application to the LSB, pursuant to its own obligations under s 28(3)(a) of the LSA 2007. This is unsurprising, given that the immediate responsibility for regulating those authorised by it, and for deciding what applications to make in respect of its regulatory arrangements, rests with that regulator.

I would like to reiterate the core theme of this letter: the LSB has pushed the SRA hard to reform and we have responded in line with LSB guidance. The pace of reform has been too slow and we should now be working together to increase it.

I trust that this letter answers your concerns.

Yours sincerely

Paul Philip
Chief Executive
Solicitors Regulation Authority