

To:	Board		
Date of Meeting:	26 May 2011	Item:	Paper (11) 39

Title:	Internal Governance Rules – May 2011		
Workstream(s):	Securing independent regulation		
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Status:	Protect		

Summary:

This year's Internal Governance Rules (**IGR**) exercise shifted the focus of the work from reviewing the newly established governance arrangements to insisting on practical and effective measures to embed those arrangements in systems and the conduct of personnel. To do so, we required Applicable Approved Regulators (**AAR**) to complete a risk assessment and answer a series of AAR specific questions.

We have received completed certificates and risk assessments from CIPA / ITMA / IPREG and ILEX / ILEX PS.

An update on their progress to IGR compliance was received from ACL / CLSB. An extension was agreed with the Bar Council / BSB, with whom we will begin discussions early next month. A draft response was received from the Law Society / SRA; although this is not considered in this paper. The Chief Executive will give an oral update on the discussions held with his counterparts in both bodies.

We recommend that CIPA / ITMA / IPREG and ILEX / ILEX PS arrangements are deemed compliant with the IGR rules and the Legal Services Act 2007. However, a number of risks to independent regulation are evident from CIPA / ITMA / IPREG's response. We will make clear our expectations of what they will need to do in order to mitigate and/or avoid these risks in our response to them. ILEX / ILEX PS' submission raises fewer risks and those risks that are evident appear appropriately mitigated. The ACL / CLSB action plan is ambitious but possible.

A common issue that has been identified is that there appears to be some level of confusion about what is the appropriate level of oversight of the regulatory arm by the Approved Regulator (**AR**). The LSB believes that such oversight is necessary but it is limited. We propose to conduct more work on what we think is the appropriate balance between oversight by LSB and residual oversight by ARs with representative functions. We will report back on that and our consideration of the outstanding responses at the July meeting.

Risks and mitigations

Financial:	N/A.
FoIA:	Initial assessment: Annex A1-2 and C1 – s22 Annex B and C2 – s44.
Legal:	The bodies considered in this paper here have been deemed compliant with the Act and the rules in relation to independence.
Reputational:	High profile area which is one of three key LSB business priorities.
Resource:	N/A.

Consultation	Yes	No	Who / why?
Board Members:		✓	Not possible due to tight timeframes.
Consumer Panel:		✓	
Others:	No		

Recommendations:

The Board is invited:

- 1) to agree the proposed response to the ACL (CLSB), CIPA (IPReg), ITMA (IPReg) and ILEX (ILEX PS)
- 2) to delegate any further actions in relation to the ACL (CLSB), CIPA (IPReg), ITMA (IPReg) and ILEX (ILEX PS) and the IGR 2011 exercise to the Executive.

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This year's exercise

1. This year our business plan made it clear that we would conduct an IGR exercise during 2011. However, we said that we would shift the focus of the work from reviewing the newly established governance arrangements and instead review the practical measures taken by AARs to embed independence in systems and the conduct of personnel.
2. To investigate these areas, we designed a risk matrix to provide an open and transparent framework for assessing and monitoring compliance. The matrix was grouped around the following five different risk areas:
 - a. Governance – this risk area is focused on ensuring the regulatory arm acts in the interests of the consumers not the profession
 - b. Shared services – we felt that if shared services exist, they should be at a similar standard to those which could be provided by an external body
 - c. Freedom to set strategy and resources – the regulatory arm should be free to set their strategy and determine the level of resources needed according to the regulatory risks
 - d. Freedom to access and manage resources – the regulatory arm should be able to react to changes in regulatory risks and be free from disproportionate scrutiny
 - e. Application processes – rule change applications are made to address regulatory risks identified by the regulatory arm.
3. The regulatory arm and representative body of each AAR were asked to provide an indicative 'RAG' rating for each of the risk areas and provide commentary on the rationale for the risk rating given.
4. In order to enable the LSB to make its assessment on the level of compliance with the IGRs and evaluate the risks to independent regulation from the AAR's arrangements, practices and culture we asked each AAR a number of questions. Some of these questions were simply asking for an update on work they agreed to undertake during last year's IGR exercise; others sought information about general independence issues; and a number of questions were tailored to each AAR and based on issues that we believed were particularly pertinent.
5. To speed up the process this year, and to perhaps uncover a more candid appraisal of the AARs' arrangements, we asked the regulatory arm and representative body to provide draft responses to the LSB promptly. We also arranged a series of tripartite

meetings to explore any issues of conflict. Finally, to complete the process, the AARs were asked to submit an agreed dual self-certificate of regulatory independence.

Update on progress / exceptions

6. We received draft risk assessments and completed question responses from ILEX, ILEX PS, CIPA and ITMA, IPReg, The Law Society and the SRA.
7. The Law Society and SRA draft responses identified a number of issues that will require an extended period of contemplation before they will be able to agree a final response. Therefore we have allowed them some more time. An oral update will be provided to the Board on the emerging issues and progress in relation to The Law Society and SRA. We agreed an extension to The Bar Council and BSB submission at their request. The Bar Council / BSB and The Law Society / SRA response will be covered in more detail at the July meeting.
8. We did not ask the ACL and CLSB for a completed risk assessment or certificate. This is because the CLSB is only in early start up. Last year the action plan presented to the LSB by the CLSB made it clear that it would not be fully compliant with the IGRs until November 2011. When it does declare itself fully up and running we will expect it to complete a regulatory independence certificate and we will make an assessment of its compliance. We did ask the CLSB to provide an update on its progress against its action plan and for details of its next steps to achieve compliance with the IGRs.
9. The other ARs are not AARs and so do not have to complete a regulatory independence certificate and have been exempted from this exercise.
10. This paper therefore only seeks approval from the Board to accept the completed certificates from ILEX / ILEX PS and CIPA / ITMA / IPREG. It also seeks acceptance of the ACL / CLSB action plan.

The right sort of oversight

11. The review of the submitted risk assessments and question responses revealed a lack of understanding of the residual oversight role for the ARs.
12. Looking across the AARs, two types of structure have been favoured for the regulatory arm – a separate company owned by the AR(s) or the creation of an autonomous division within the AR. Because of these structures, and ultimately the Act guides you to one or the other, financial, regulatory and legal liability remains with the AR; for instance, if we felt compelled to take enforcement action against the SRA, any fine (if that were the enforcement action chosen) would be levied on The Law Society. However, the principle of regulatory independence is a central tenet of the Act and our rules require the delegation of the performance of all regulatory functions to a body or bodies without any representative functions.
13. These apparent conflicts have led to each AAR devising their own oversight arrangements for their regulatory arms, with differing levels of success. At their worst, the arrangements adopted have led to fractious relationships and accusations that the representative body is attempting to control the AR or representative bodies feeling that they are having independence ‘shoved down their throats’.
14. Our initial view is that oversight is legitimate, but it is limited. Once an AR has set the parameters of the regulatory arm’s activity, delegated regulation to it and appointed a regulatory chairman / board, their activities should cease to be about operational matters. They should then concentrate on satisfying themselves that the regulatory board is carrying out its role of holding the executive to account for regulatory matters. The AR could determine ‘group wide’ risk, finance and governance policies and check

against these; but this is not the same as determining regulatory policy and activity or using processes to fetter activities.

15. The issues detailed above highlight the need for careful thought and we think that it may be worthwhile to look more deeply into this issue as this year's exercise finishes. It also underlines the importance of the Board continuing to pursue its agenda on regulatory effectiveness: the more we can provide assurance to ARs and the regulated community that the effectiveness of regulatory arms is being properly assessed, the less need there is for activity that is potentially duplicative in effect and/or might offend in the IGR context.

Individual AAR summaries

16. Below is a table summarising some of the key details provided by the AAR submissions; the risks and issues that the LSB has identified; and our recommended next steps.

Table 1: Summary of AAR submissions to IGR 2011

AAR	Comments on submission received	Risks / issues identified	Next steps
ACL	<p>Considering the CLSB's small budget, substantial progress has been made.</p> <p>We believe that it should be able to meet the deadline it has set.</p>	<p>The amount of work the CLSB will have to carry out raises a number of risks to its deadline for compliance. This will only arise if the process of rule approval is more complicated than it envisions and so requires more time for approval.</p>	<p>Our initial reply to CLSB stressed the needed for a quality consultation.</p> <p>The Executive is reviewing the published consultation documents to ensure that we are prepared for the submission of the rule change.</p>
CIPA / ITMA	<p>IPReg's regulatory arrangements are compliant with the rules and the Act.</p> <p>It now has a lay majority and significant lay involvement within its committee structure.</p> <p>IPReg has started an AR forum as an oversight mechanism for the AARs.</p>	<p>The bodies need to formally agree the changes to the delegation agreement.</p> <p>The responses suggest that CIPA / ITMA still wish to have the ability to control IPReg above and beyond the appropriate level of oversight, especially in relation to budgetary issues, although this risk is lower than last year.</p> <p>CIPA and ITMA feel that they do not receive enough timely information from IPReg.</p> <p>It is possible that CIPA and/or ITMA will attempt to exert undue influence during the budget setting process again.</p>	<p>The bodies will be reminded of the need to formalise their delegation agreement.</p> <p>We will encourage them to give the new AR forum a chance to bed down as an oversight mechanism.</p> <p>We will include them in any discussions about the appropriate level of residual oversight.</p> <p>We will encourage IPReg to provide documentation to ITMA / CIPA at the appropriate time.</p> <p>We will remind CIPA and ITMA of the advice we provided last year in relation to budget setting.</p>

AAR	Comments on submission received	Risks / issues identified	Next steps
ILEX	<p>ILEX PS' arrangements are compliant with the rules and the Act.</p> <p>ILEX PS has updated its protocols, as requested by the LSB last year.</p> <p>ILEX has reviewed and made minor changes to its services level agreement following requests from ILEX PS.</p>	<p>ILEX and ILEX PS' response suggests that their arrangement's mitigate the risks identified.</p> <p>ILEX PS remains reliant on ILEX for many of its services. However, the SLAs appear robust, are regularly reviewed and no disputes have arisen.</p> <p>There remains suspicion that the applications and major regulatory matters, such as QAA, are heavily influenced by ILEX, but there is little evidence that suggests this is 'undue' influence.</p>	<p>We propose no further actions in relation to ILEX / ILEX PS and independence.</p> <p>Significant work with ILEX will continue through the various ongoing projects; including, but not limited to, the smaller AR work, developing regulatory standards and their ongoing applications.</p>

Conclusion

17. This year's approach to the IGRs has allowed LSB to adopt a risk-based approach and has delivered a process that has been able to ask awkward questions of the AARs. What has emerged is that there remains confusion about what is the legitimate level of oversight of the regulatory arm by the representative body. As this year's exercise finishes, it may be useful to spend some time looking at this issue.
18. The Bar Council / BSB submission and an update about The Law Society / SRA submission will be presented to the Board in July. In the meantime, we ask the Board to approve our proposed response to the ACL (CLSB), CIPA (IPReg), ITMA (IPReg) and ILEX (ILEX PS) and to delegate any further actions in relation to these bodies and the IGR 2011 exercise to the Executive.
19. We do not propose to publish our full assessment until the Board has reviewed The Bar Council / BSB and The Law Society / SRA response.

List of Annexes:

- Annex A1: Letter from the CLSB (12 April 2011) regarding its progress in relation to achieving compliance with the IGRs
- Annex A2: CLSB action plan (as at 11 April 2011)
- Annex B: Collated draft responses from CIPA / ITMA and IPREG to the regulatory independence risk assessment and certificate questions
- Annex C1: ILEX and ILEX PS draft dual self-certification of regulatory independence
- Annex C2: ILEX and ILEX PS draft risk assessment response.