Annex D

Schedule 13 review

Overview

1. Schedule 13 of the LSA sets out the requirements for non-lawyer owners to be approved by licensing authorities. The schedule is detailed and prescriptive in nature, with numerous tests to identify those non-lawyers needing approval as well as the requirements on which the relevant licensing authority must be satisfied.
2. Our early expectation for this review was that, after confirming that current licensing authority arrangements are consistent with the LSA, we would propose modifications to schedule 13 to the MoJ. On the basis of work so far (and the length of time that the MoJ is taking to progress orders on a range of other issues), a change of direction is needed. Our focus now is on SRA processes and procedures, where there is the possibility of quick improvements. These should then enable us to test whether the schedule should be amended.

Background

3. The work forms part of our response to the MoJ review of the legal services statutory framework and blueprint for reforming legal services regulation.[1] It sits within legislative and regulatory simplification, in terms of lower costs and entry barriers being possible through the introduction of a new simple "fit and proper" test for ABS owners. This reflects that the intent of the LSA to enable innovation through ABS appears to be impeded by (among other things) issues associated with the ownership test in schedule 13. This has the intent that, as far as possible, people with improper significant influence are detected. Its prescriptive nature may be resulting in licensing authorities requiring significant numbers of intrusive checks on those associated with ABS applications.
4. The LSB's guidance to licensing authorities[2] says that we expect them to implement schedule 13 in a proportionate way to ensure that different types of ABS ownership are not unduly restricted. However, the requirements are still detailed and extensive in nature.
5. The schedule requires a licensing authority to approve relevant non-authorised persons before granting a licence. Where a licence is already in place, material interests should not be acquired without the licensing authority's prior approval (which is clearly problematic for listed companies). Eight criteria determine if a qualifying material interest is held (relating to shareholdings and voting power) either individually or together with associates (which is widely defined).
6. The criteria can potentially create a long corporate chain of material interest holders, for example because the 10% shareholding threshold can relate to parent companies[3] not just to the ABS itself. This may result in individuals

---

[1] http://www.legalservicesboard.org.uk/what_we_do/responses_to_consultations/pdf/a_blueprint_for_reforming_legal_services_regulation_lsb_09092013.pdf paragraphs 32 and 143

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

[3] defined in section 420 of the Financial Services and Markets Act 2000 and, in turn, section 1162 and schedule 7 of the Companies Act 2006

remote from an ABS requiring approval. The approval requirements[4] mean that a licensing authority must be satisfied on a number of matters (e.g. if a person is a fit and proper to hold the interest, which in turn (among other things) involves consideration of the person's probity and financial position and that of their associates).

7. It is possible to modify certain paragraphs in the schedule, by order of the Lord Chancellor (on the LSB's recommendation), via paragraph 9.[5] The sections that can be modified concerned with how material interest is calculated, and the individuals considered to be associates of an applicant for the purposes of interest holdings and suitability.

8. Licensing authorities typically expect relevant individuals to provide information via an application form and to consent for it to be validated. By virtue of an exception to the Rehabilitation of Offenders Act 1974, licensing authorities can ask about and carry out checks (via the Disclosure and Barring Service) on spent and unspent convictions of material interest holders. Other information sources assist investigation, for example, open sources like the Insolvency Service and Companies House, MoU with other regulatory bodies, and credit references from organisations like Experian.

9. Our review was intended to understand perceived issues associated with schedule 13 and their underlying causes, what changes these might suggest (e.g. via paragraph 9), and what such changes might propose. It was anticipated that issues would fall into one of three categories relating to:

    - the processes put in place by licensing authorities for licensing ABS
    - LSA requirements for which a potential route for change appears to exist (for example, via paragraph 9 of the schedule)
    - LSA requirements without an apparent route for change.

10. For those in the first group, it may be possible to introduce change fairly quickly. For the second, however, it is taking at least a year for MoJ to introduce orders (from initial planning through to implementation for normal procedures). In any case, before bringing forward proposals to change the schedule, we would want to be satisfied that licensing authority arrangements do not create unnecessary and avoidable regulatory burdens in addition to those which flow from primary legislation.

11. Our current focus is on actions prior to a licence being granted, such as the identification of owners and the checks carried out on them, as well as the scope for modifying aspects of these.[6] The remainder of the schedule[7] concerns the duties of licensed bodies and the powers of licensing authorities once a licence has been granted.

---

[4] schedule 13 paragraph 6

[5] The Lord Chancellor may, on the recommendation of the [Legal Services] Board, by order modify –
(a) paragraph 3 (material interest)
paragraphs 4(2), 5, 6(3)(c), 38(3), 41(3) and 42(3) (associates)

[6] As set out in parts 1 and 2 of the schedule – paragraphs 1 to 20, in particular paragraphs 3 (material interest) and 5 (associates), which may be modified via paragraph 9 (Lord Chancellor's power to modify), and paragraph 6 (the approval requirements)

[7] parts 3 to 5 – paragraphs 21 to 51

Work so far

Discussion with ABS sector participants

12. We have reviewed respective ABS application material and also discussed schedule 13 with the Council for Licensed Conveyancers (CLC) and, to a greater extent, the Solicitors Regulation Authority (SRA). This reflects that the SRA has perhaps had more experience of applying the schedule to applications featuring complex ownership arrangements. We also gave the Institute for Chartered Accountants in England and Wales (ICAEW) and Intellectual Property Regulation Board (IPReg) the opportunity to be involved, given their forthcoming licensing authority status. Despite initial positive indications, ICAEW did not respond ultimately. IPReg indicated that it would welcome the opportunity to be involved in any group discussion, but does not feel able to comment otherwise at this stage. [redacted]

13. Work with the SRA and CLC has included understanding their current processes and procedures, including the legal basis for them, as well as giving them the opportunity to indicate concerns about legislative requirements.

14. Generally speaking, the CLC is of the view that LSA requirements are a proportionate response to the risks posed. Its instinct would therefore be to oppose change. It did indicate, though, that when assessing applications it only goes as far up the corporate chain as it considers necessary to gain reasonable assurance of the main stakeholders. Although the vast majority of its applicants to date have been previously recognised bodies that it was already familiar with, it has dealt with private equity structures. This might suggest that it is applying a more proportionate interpretation of schedule 13 than the SRA.

15. The SRA's view is that the schedule's provisions are prescriptive, and that it has no scope to deviate from them. This is regarded as capturing significant numbers of material interest holders associated with applications, on which checks must be carried out. It believes that modifying the LSA to give licensing authorities discretion could address this, but has not considered what this might look like in practical terms. It recognises, though, the benefit of reviewing its current approach before making a case for changing the schedule. With this in mind we have arranged a meeting in late May.

16. In the meantime, both the CLC and SRA have confirmed they agree with and are applying our interpretation of who they are legally allowed to carry out criminal record checks on.[8]

17. We also approached a number of ABS, in particular some that have expressed views on the authorisation process, in public and/or directly to the LSB. The five we have spoken to so far obviously do not represent a statistically robust sample, but were intended to identify if there may be issues that warrant further consideration. Perhaps unsurprisingly, given the points noted above, they are

[8] Holders of restricted interests under schedule 13 and holders of Head of Legal Practice and Head of Finance and Administration roles may have checks carried out on both spent and unspent convictions. Only information on unspent convictions can sought for other individuals/roles.

authorised by the SRA. While widely varying business structures were involved, recurring themes were raised. Their comments, which are considered below, will be used to inform our discussion with the SRA this month.

Review of the provisions of schedule 13

18. Our work has revisited key provisions of schedule 13, with a view to the obligations on licensing authorities. We have also considered the drafting of paragraph 9 limits its scope for change, by virtue of the Lord Chancellor having the power to "modify" certain provisions.

19. Our view of the material interest (ownership) test[9] and related definition of associates[10] is that they are prescriptive and do not allow licensing authorities to exercise discretion. This could result in a large pool of persons requiring approval.

20. In contrast, the precise approval requirements[11] for those who do have a material interest do appear to allow exercise of judgement. This is because although licensing authorities must have regard to and be satisfied on certain matters, no standard is specified for satisfaction. As such, a risk based/proportionate approach can be applied, for example with a greater level or lesser level of assurance sought depending on the individual circumstances. It does not appear that the SRA recognises this, so we will raise this with it. Following this, we may want to consider whether clarification is needed in the LSB guidance to licensing authorities on the content of licensing rules.

21. Changes via paragraph 9 are clearly limited to the provisions listed in it. Scope provided by the term "modify"[12] may be somewhat at odds with limits suggested by the formulaic nature of existing drafting. In any case, it is likely to depend on the view of the Ministry of Justice (MoJ). For example, the extent to which changes are considered to facilitate policy objectives, versus exceeding parliament's intent and needing primary legislation. Other than this, there is no immediately apparent route to deliver relevant amendments across all licensing authorities.

22. In the event that we wish to pursue recommendations to the Lord Chancellor, it would seem sensible to have considered proposals before engaging with MoJ. This area of work has therefore not yet been discussed in any detail.

Consideration of comparable regulatory arrangements

23. Legislation applying to, and the approach and experience of, regulators facing comparable risks (e.g. protection of consumers and prevention of criminal activity) have been discussed with the Financial Conduct Authority, Office of Fair Trading[13] and Gambling Commission. A summary of relevant legislation is at Annex 1 to this paper. Broadly speaking there are commonalities. For example, 10% as a threshold for identifying some interest holdings needing approval. However, there is no real consistency or clear rationale for the different legislative approaches across the sectors.

---

[9] paragraph 3
[10] paragraph 5
[11] paragraph 6
[12] defined in section 207: "modify" includes amend, add to or revoke...
[13] although in this case with a historical perspective, recognising that its responsibilities for consumer credit licensing transferred to the FCA on 1 April 2014

24. Learning points, e.g. on thresholds for material interest, application documents, and use of information, will be borne in mind for possible future changes to schedule 13, and used to inform feedback to licensing authorities.

Issues associated with current ABS authorisation

25. Views expressed by licensing authorities (in particular the SRA) and ABS that we have spoken to have been considered against the three categories referred to above at paragraph 7. These are explored below in turn.

Issues associated with the processes of licensing authorities (category 1)

26. The majority of comments by the ABS we spoke to fell into this category and related to the SRA. Observations will be shared with the SRA on an anonymised basis ahead of our meeting later this month. These roughly fall into two areas, on approach and quality.

27. The SRA generally appears to have a risk averse approach to ABS authorisation. This includes that way in which it interprets and applies schedule 13. It has made use of a provision[14] which means that all partners in a partnership are automatically judged to hold material interest in an ABS, thereby widening the pool of those needing its approval. By comparison the CLC has not. The impact of this position has not been assessed, but can be expected to increase burden on a number of applications and the SRA in assessing them.

28. It also appears to have adopted a uniform (and very high) standard for approving material interest holders. The proportionality of seeking detailed information from those far removed from decision making (and in some cases unlikely to be aware of the ABS) was queried by some of those we spoke to.

29. [redacted]

30. Caution is also illustrated by the language used in SRA guidance material and application forms on criminal offences, and their impact on decision making. For example, if a candidate has ever been convicted of particular types of offences (e.g. for which they received a custodial or suspended sentence), the SRA will refuse their application unless there are exceptional circumstances. It was noted that this can effectively exclude individuals from continuing to complete forms and does not allow for rehabilitation. This contrasts with their treatment by some other regulators and may, in any case, need to change depending on the outcome of an impending Supreme Court judgement.[15]

[14] paragraph 3(2)(b) of schedule 13

[15] the Government appealed a Court of Appeal judgement that legislative provisions on criminal records disclosure are incompatible with Article 8 of the ECHR, and that Parliament must devise a new proportionate scheme

31. At a day to day level, it was also noted that changes in SRA case handlers created duplication of work. This was because each individual sought to satisfy themselves on the quality of their predecessor's work.

32. The logic of the SRA's stance on authorisation was also queried. This appears in part due to drafting in its rules. [redacted]

33. [redacted]

34. [redacted]

35. Obviously in any process there will be a learning curve and some ABS noted improvement over time, particularly on the availability and relevant expertise of SRA staff. There is, though, clearly still room to improve. [redacted]

Issues associated with schedule 13 with a route for change (category 2)

36. As discussed above, the route for change (via paragraph 9 of the schedule) relates to the material interest thresholds and associates, which collectively establish those persons who must be approved by licensing authorities. There is clear overlap between issues in this category and those noted above. As such, it is currently difficult to distinguish between the consequences of the SRA's licensing arrangements and the schedule.

37. Key points are discussed at a high level below. These would not necessarily work together and would require further exploration.

    - lack of discretion for licensing authorities to determine persons of interest associated with applications. An approach akin to that in the Gambling Act 2005, with a disclosure threshold and subsequent ability by a licensing authority to exercise judgement, could merit consideration. Success would, among other things, rely on identifying thresholds that strike the necessary balance between adequate information being available and burden on applicants, and the licensing body adopting a proportionate approach

    - application of materiality thresholds at all levels of the corporate chain. This currently has the effect of catching a potentially vast number of

individuals, regardless of their proximity to the applicant. Restricting this to applicant/applicant and parent company level would narrow the pool of those required to submit detailed information to a licensing authority

- the broad definition of associates. Again, this can increase the list of those deemed to have material interest. Narrowing the definition, for example removing children and stepchildren of applicants, could be in keeping with other sectors. Applying a minimum, e.g. 3%, interest holding threshold to associates would also be in keeping, although this is already part of the LSB guidance to licensing authorities and has been adopted by the CLC.

Issues associated with schedule 13 with route for change (category 3)

38. A common criticism of schedule 13 is that it does not envisage legal firms being listed. This is seen in the need for pre-approval of material interest holders. The impact of this might potentially be lessened by changes to reduce the scope of those captured by material interest tests. Assuming adequate arrangements are available to a regulatory body to deal with concerns, post-approval would be more fitting. This will be raised with MoJ as part of any future discussions.

39. A wider point relates to the need for increased information sharing between regulators and government departments. While it is discussed in the LSB guidance, it is in some cases hampered by legislation. This has the potential to reduce the burden on applicants, e.g. reducing the need to submit paper based material such supporting evidence for identity and residence.

Conclusions

40. Work to date suggests that a substantial amount of issues associated with schedule 13 may be related to the SRA's (but in comparison not the CLC's) application of it, and are therefore within its ability to remedy. Indications are that it has the appetite to do this and is seeking our input, at least at this stage, into the process. We should therefore look to work with it to make rapid improvements.

41. Publishing a review of current arrangements and expected next steps may serve to maintain momentum. If necessary, this could also serve as consultation on changes to the LSB guidance to licensing authorities on licensing rules. In any case, it is not currently possible to take a proper view on whether changes are needed to schedule 13.

42. In view of the above, we are adjusting the direction of this project from that originally planned, with work to address SRA processes and procedures as stage one. Once changes have had time to take effect, stage two would be a further thematic review of the need to modify schedule 13.

ANNEX 1

Ownership in other regulated sectors

The information below is a very brief summary of legislation applying to different regulatory sectors where some comparable risks are present. It therefore should not be treated as comprehensive.

The Financial Conduct Authority (FCA)

Some business types are regulated by the FCA for business conduct and by the Prudential Regulation Authority (PRA) for prudential requirements. The PRA is lead regulator of dual-regulated firms, with the FCA authorising solo-regulated firms. The FCA's approach is prescribed by a number of different pieces of legislation.

A firm must satisfy the FCA that it can meet threshold conditions and that all persons who own or manage it are fit and proper. The threshold conditions include that controllers (i.e. owners) and close links must not prevent effective supervision.

Controller thresholds vary depending on the activities undertaken and exceptions, but generally involve (whether acting alone or in concert, i.e. akin to associates):

- holding 10%/20%/33% or more of shares or voting power in a firm/its parent
- holding shares or voting power in the firm/its parent undertaking that enable exercise of significant influence over the management of the firm
- Further checks apply if holdings increase (prior approval is needed for changes and increases), so controllers may be re-assessed.

Close links again hang on business type, but generally involve control relationships, e.g. of 20% or more of an undertaking's (or its close link's) voting rights or capital, and connected undertakings such as parents and subsidiaries. In practice, there is often overlap between controllers and close links.

In terms of fit and proper status, for some functions the FCA has regard to honesty, integrity and reputation, competence and capability, and financial soundness. Applications must be determined by the regulator within 6 months, or 12 for incomplete ones. They are deemed approved if these deadlines are not met. In practice, though, well prepared applicants appear to be processed more quickly.

The Gambling Commission (GC)

The GC was established by the Gambling Act 2005 (GA). The GA imposes disclosure thresholds on interests held in applicant businesses (but not parent companies etc. as per the LSA):

- 3% equity holdings must be listed, 10% and over require detailed disclosure
- detailed information/a personal licence is required for management positions.

Where interests are held by other entities, the Commission investigates until:

- no entity holds more than 3%
- an identified person is reached

- a regulated entity meeting probity obligations (e.g. FCA regulated) is identified.

The 10% threshold is a starting point, as the GC can check anyone considered pertinent to an application. Suitability is assessed in terms of the applicant and relevant persons, including the ultimate owner, their finances (past, present and prospective), integrity and competence. Wide ranging and detailed information can be required and checked in these areas.

The GC indicates that it takes a risk based and proportionate approach, including on information requirements. Typically, fewer than 10 individuals are checked in detail per application. It has a team of around 30, processing over 3,000 applications a year. Complete and uncomplicated ones take around 6 weeks, with novel and contentious ones taking a little longer. While applications must be pre-approved, changes in corporate control can be notified within 5 weeks of taking place, with the GC comfortable that it can revoke a licence if necessary.