

<b>To:</b>	Board
<b>Date of Meeting:</b>	24 March 2010
<b>Item:</b>	Paper (10) 18

<b>Title:</b>	ABS – Guidance on licensing rules
<b>Workstream(s):</b>	Widening access to the legal services market
<b>Presented by:</b>	Fran Gillon, Director of Regulatory Practice fran.gillon@legalservicesboard.org.uk / 020 7271 0087
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<b>Status:</b>	Restricted – development of policy

<b>Summary:</b>
<p>This paper sets out:</p> <ol style="list-style-type: none"> <li>1. A summary of the responses to the LSB's consultation on its draft guidance on licensing rules that closed on 19 February, the LSB's consideration of the responses and the recommended final policy position (<b>Annex A</b>). Copies of all the responses will be available at the meeting.</li> <li>2. Final guidance to potential Licensing Authorities (<b>LA</b>) on licensing rules (<b>Annex B</b>), which includes the outcomes that we want alternative business structures (<b>ABS</b>) to achieve. (This is a standalone document and does not re-state the policy decisions in Annex A.) This follows closely the requirements of the Legal Services Act 2007 ('<b>the Act</b>') and sets out what LA applicants will need to include in their licensing rules.</li> <li>3. Final impact assessment of the guidance (<b>Annex C</b>).</li> </ol>

<b>Risks and mitigations</b>	
<b>Financial:</b>	N/A.
<b>FoIA:</b>	Exempt – policy development.
<b>Legal:</b>	There is a risk that the relevant parts of the Act (in particular Schedule 10 that provides the mechanism for Approved Regulators ( <b>AR</b> ) to become LAs) will not be commenced prior to an election. However, legal advice is that ARs can continue their preparations, including developing licensing rules. We will provide a further update at the meeting.
<b>Reputational:</b>	This is a key policy issue and there is therefore a serious reputational impact if our approach to ABS is unsuccessful. This is mitigated by continuing close discussions with those ARs interested in becoming LAs, and with those firms that may become ABS. We are also ensuring that our research programme provides a baseline against which to monitor changes in the provision of legal services (both ABS and non-ABS).
<b>Resource:</b>	Resource overall for the ABS project is stretched. New starters should help to ease this once they are up to speed.

<b>Consultation</b>	<b>Yes</b>	<b>No</b>	<b>Who / why?</b>
<b>Board Members:</b>	✓		Steve Green, Andrew Whittaker, Rosemary Martin
<b>Consumer Panel:</b>	✓		Steve Brooker, Alanna Linn
<b>Others:</b>	N/A.		

**Recommendations:**

The Board is invited:

- (1) to discuss the contents of the papers and provide feedback on them, in particular to the policy issues raised below;
- (2) to agree in principle that there should be an unlimited financial penalty that an LA can impose on an individual or entity and note that work will continue with Ministry of Justice to produce a final version of rules that will come back to the Board to make formally;
- (3) to note the work that continues after publication; and
- (4) to agree to delegate authority to publish as soon as possible after the Board meeting to the Chairman and the Chief Executive.

## LEGAL SERVICES BOARD

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### ABS – Guidance on licensing rules

#### Recommendation(s)

The Board is invited:

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- (3) Note the work that continues after publication; and
- (4) to agree to delegate authority to publish as soon as possible after the Board meeting to the Chairman and the Chief Executive.

#### Background / context

1. On 18 November 2009 we published a consultation document on our guidance to LAs on the content of their licensing rules. The document proposed an 'outcomes-based approach' to regulating ABS, which focuses on the outcomes that we expect will support the regulatory objectives. We proposed that we should set out a framework of core outcomes that LAs will be required to adopt when they regulate ABS.
2. The consultation closed on 19 February and we received nearly 50 responses. These have been analysed and summarised, both by respondent and by subject matter. To get an overall 'feel' for the level of consensus over our proposals, we judged the responses on a four-point scale of strongly negative to strongly positive.
3. In general there was a surprising degree of consensus. Where people responded, they tended to be strongly or partially positive about our proposals, including the proposal that there should be a shift to outcomes (and general support for the outcomes proposed). Two issues (PII/compensation and access to justice) had a more even split of those supporting / not supporting our proposals, reflecting the difficult policy issues that both subjects raise.
4. Key policy issues are discussed in the document at Annex A. In general there are few changes from the Board's preferred policy position in October. We plan to publish our final guidance on the afternoon of the Board meeting to ensure that this major milestone in market liberalisation is not caught in any election purdah.

#### Key issues

5. This section highlights the main areas of risk associated with ABS and explains how our approach in the guidance seeks to mitigate them.

### *Hierarchy of duties*

6. Overall, respondents had slightly negative views about introducing a hierarchy of duties along the lines of the Australian model. This would require a listed company (or other ABS) to set out a formal hierarchy of duties in its constitutional documents, including a clear statement of the regulatory duties that apply to its commercial activity by virtue of being a regulated legal services provider. The principle would be that a duty to a shareholder or other stakeholder does not compromise the duties owed to the court and to the client.
7. Those respondents who supported the proposal felt that it would provide additional comfort for consumers and might act as a deterrent in some cases. Those who did not support the proposal (including the Solicitors Regulation Authority (**SRA**)) did not consider that it was possible for such a device to work in practice given the duties in the Companies Act 2006.
8. The Act provides the following protection:
  - section 90 places a duty on non-authorized employees and managers, and owners, not to do anything that causes an ABS to breach the duties imposed by section 176;
  - section 176 places a duty on authorized persons and their employees and managers to comply with the regulatory arrangements of an AR;
  - divestment provisions in the event that a LA decides that an owner is not fit and proper; and
  - enforcement powers including financial penalties for breaches of licence.
9. This could therefore be seen as giving a statutory basis to the duties that lawyers have to their clients and to the court, whoever the owner of the entity is. We do not know whether a formal hierarchy would be practical or enforceable and to put it forward as a consumer protection measure on that basis could provide false comfort.
10. Our recommendation is therefore that our guidance states that we do not consider that it will be necessary in most cases to impose additional requirements on an ABS. It may however be appropriate for a LA, in the particular circumstances of a licence applicant, to require additional safeguards in relation to ownership or influence. We would expect any such requirement to be objectively justified, with a right to appeal against it.

### *Fit and proper tests*

11. The concerns expressed about improper influence on an ABS, whether by an owner, manager or employee, are addressed in the requirements for a fit and proper test for owners, the Head of Legal Practice (**HoLP**) and the Head of Finance and Administration (**HoFA**). This test will be common to all LAs to ensure that consumers are protected in the same way, whatever LA regulates the ABS. The guidance sets out the details of the test.

### *HoLP/HoFA*

12. The Act requires an ABS to have a HoLP (who must be a lawyer) and a HoFA. Because of the requirement that the HoLP is a lawyer, in order to ensure that small entities can become ABS, we do not consider that it is appropriate to also require that the HoFA is a qualified accountant. However, the guidance makes clear that we would expect the HoLP's and HoFA's expertise, capability and experience to be appropriate to the size and type of ABS and that this should inform the LA's assessment of whether to accept the person's designation for either post.

### *Indemnity and compensation arrangements*

13. Consideration of indemnity and compensation arrangements has raised a number of issues that apply to both ABS and non-ABS. We will continue the discussions that have taken place with interested parties about what, if any, changes should be made to requirements generally to achieve an appropriate balance of consumer protection and commercial flexibility.

### *Access to justice*

14. In terms of an appropriate policy towards the Act's requirement that licensing rules must contain provision as to how the LA should take account of the objective of improving access to justice, we do not consider that it is proportionate to expect LAs to have specific tests to measure access to justice in relation to ABS alone. There are a number of changes taking place in the legal services market that may have an impact on access to justice. These include not just ABS but also the way in which legal services are regulated, and political, economic, social and technological factors. It is unlikely that any one of these factors alone will be able to be identified as the cause of any change in access to justice. We therefore expect ARs/LAs to monitor the various factors that influence access to justice across all those they regulate and to work with us to understand the dynamics and interaction of these factors. We will consider further how best to capture the output of this monitoring and whether any formal reporting requirements are required: although ABS provides one clear vehicle for extracting both hard and soft information on the subject, we should also consider whether some of the possible benefits might be obtained through a wider exercise, such as the possible 'State of the Legal Market' report that the Board suggested might be explored as an option at an earlier meeting.

### *Special bodies and Legal Disciplinary Practices (LDP)*

15. There were mixed views on the speed at which special bodies such as CABx and Law Centres should be brought within the ABS framework, although overall the view was that they should be. Similarly, there was general support for a transitional period of 12 months for those entities that are, in effect, ABS now in order to give the ability to choose when they apply for a licence. On balance, given all the other changes taking place before ABS 'go live', we consider it reasonable to have a 12-month transitional period for those entities that are currently ABS or LDPs, other than special bodies where an 18-month transitional period is more appropriate.
16. For special bodies there is considerably more work to be done than for LDPs. In particular, we will need to work with their umbrella organisations (such as CABx head office, the Law Centres Federation and the Advice Services Alliance) in

terms of the changes needed to be able to comply with licensing rules. For this sector in particular, we will need to have an accurate assessment of the cost and benefits of having to become ABS before Ministry of Justice (**MoJ**) will agree to lift any transitional arrangements. By nature, this sector is less well engaged on ABS than mainstream law firms and, although we have raised awareness of ABS, there is still a long way to go.

17. It is also important to bear in mind that no LA will have had any experience of regulating ABS until October 2010. We will need their experience to feed into our consultation on guidance on licensing rules for special bodies which could probably be undertaken around March 2012 with final guidance in June 2012. LAs will then have to consult on any necessary changes to their licensing rules and put any required changes to us to agree, probably in autumn. This would then provide a six-month period for special bodies to apply for ABS licences.
18. If LAs feel 'bounced' into regulating special bodies they may push back and we would have to license them directly. We do not consider that the risk of the ABS licensing process going wrong for special bodies, or for the LSB to have to licence them directly, is worth taking for the sake of reducing the transitional period by a few months. Should further work reveal that there is scope for accelerating the timetable, there may be scope to do so, but we should neither over promise nor worry stakeholders at this stage.
19. We will continue discussions with special bodies, MoJ and others to put these arrangements in place and to raise awareness. We will also discuss further with special bodies and the Legal Ombudsman whether it is appropriate for voluntary arrangements to be put in place in the meantime to provide independent redress for consumers.

#### *Consumer Panel*

20. The Consumer Panel sent a helpful response to the consultation and is keen to remain involved in our future work on ABS, in particular on the issue of reserved and unreserved activities, indemnity and compensation arrangements and the future regulation of special bodies.
21. We will feed back to the meeting any particular points raised by the Panel about our final guidance. However, the Board should note the following:
  - The Panel wants an obligation on every ABS entity, its owners and managers to promote and to protect the interests of consumers. We consider that the protections set out in the Act and our guidance on how they should be interpreted are an important aspect of consumer protection. In addition, the Legal Ombudsman will provide redress where service provision is unacceptable. But it is not appropriate to impose a further duty on individual ABS given the commercial incentives to provide good customer service;
  - The Panel supports the concept of a hierarchy of duties for ABS. For the reasons given above, we no longer consider that this is an appropriate approach;
  - The Panel does not agree that there should be an outcome for consumers to make more informed choices about the risk that they are prepared to take when obtaining legal advice. The Panel proposes that there should be an explicit outcome of reducing risk to consumers. We do not consider

that these two issues are incompatible. More informed consumers should make better choices, and we have made explicit in the outcomes a reduction in risk through effective enforcement;

- The Panel wants all legal activities by ABS to be regulated, but if only reserved activities are regulated they consider that we need to ensure consumers understand the difference. We do not consider that we have sufficient evidence to justify increasing the scope of regulation as part of the introduction of ABS. Part of our work on what should be a reserved legal activity will focus on consumer understanding and the costs and benefits of increasing regulation; and
- Access to Justice – the Panel considers that the importance of face-to-face contact for some consumers must be recognised in defining access to justice (although this is not ABS-specific), but agrees that ABS firms cannot be expected to do more than traditional law firms.

### **Maximum financial penalty**

22. Most respondents who expressed a view supported the proposal that the maximum financial penalty that a LA can impose on an entity or an individual should be unlimited. We have therefore included this in our guidance with a requirement to show how they will act proportionately when imposing a penalty. The actual level of penalty has to be agreed by the Lord Chancellor. MoJ has confirmed that this process forms part of the final stage of the Act's commencement later this year. We will therefore work with MoJ to finalise the required statutory instrument and impact assessment and bring it back to the Board to formally make a rule later this year. We consider that this will provide sufficient certainty for LAs and potential ABS.

### **Next steps**

23. There is considerable work remaining after the guidance is published. This includes:

- Appellate bodies – work with MoJ, Solicitors Disciplinary Tribunal and others. Report to Board anticipated for July.
- PII/compensation arrangements (note that this is wider than ABS) – report to Board anticipated for the autumn.
- Commencement of remaining parts of the Act, associated impact assessments, ending of transitional arrangements – anticipated Parliamentary time depends on designation of LAs.
- What needs to be in a section 69 (modification of the functions of ARs etc) order – anticipated Parliamentary time depends on designation of LAs.
- Plans for direct licensing by LSB – report to Board anticipated for the autumn.
- Planning for consideration of LA applications including liaison with likely applicants – first applications expected at the end of September; recommendations to Lord Chancellor from January 2011.

- Market engagement – continuing/increasing.
- Interaction between PCF and licence fee – clarity on issues (if any) and next steps (if needed) by June.
- Regulatory overlaps (SRA is leading on this) – memorandum of understanding in place by first LA applications.
- Work with special bodies – continuing/increasing.

17.10.10