To:	Board		
Date of Meeting:	27 January 2011	**Item:**	Paper (11) 03

Title:	Regulatory approaches
Workstream(s):	Regulatory excellence
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Status:	Unclassified

Summary:

In LSB's draft Business Plan 2011/12, we set out our emerging expectations with regard to how Approved Regulators (**AR**) regulate. We emphasised our view that regulation should be based upon four distinct but complementary elements:

- An outcomes-based code
- A framework for identifying and analysing risk
- Supervision of law firm entities and individuals based upon risk
- Enforcement strategy that both deters and punishes non-compliance.

This paper expands that thinking and provides the analysis to support it. By sharing this paper at an early stage the LSB can test and develop its thinking ahead of consultation on rule and process changes related to approval of new ARs and Licensing Authorities (**LA**); addition to an AR or LA list of reserved activities; and approval of amendments to regulatory arrangements.

The LSB will use the paper to discuss with ARs and other stakeholders a self-assessment exercise that allows regulators to set out and review their progress towards this approach, explain any deviation (with regard to regulatory objectives and better regulation requirements) and develop their strategy. That in turn will allow the LSB to evaluate regulatory capacity and capability and thus better oversee the legal services market.

Risks and mitigations	
Financial:	None identified.
FoIA:	Release in full.
Legal:	None identified.
Reputational:	Tackles issue of LSB not having in place a regulatory review process.
Resource:	Fits within current resource planning for rule approval and other regulatory decision-making. Self-assessment process may create additional resource pressure to be managed alongside thematic review choices.

Consultation	Yes	No	Who / why?
Board Members:		✓	A ‘work in progress’ draft was circulated to the Board on 13 January.
Consumer Panel:	✓		
Others:	Business planning / research seminars.		

Recommendation(s):

The Board is invited:

(1) to note, comment upon and agree the rationale for setting out regulatory expectations;
(2) to agree to the sharing of the final version of the paper with the ARs;
(3) to agree to the Executive developing detailed plans for updating the existing process and rules in light of this paper; and
(4) to agree to the Executive developing a self-assessment plan for ARs to assess how far their approach to regulation is fit for purpose.

LEGAL SERVICES BOARD

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Executive Summary

1. **Recommendations**

The Board is invited:

(1) to note, comment upon and agree the rationale for setting out regulatory expectations;
(2) to agree to the sharing of the final version of the paper with the ARs;
(3) to agree to the Executive developing detailed plans for updating the existing process and rules in light of this paper; and
(4) to agree to the Executive developing a self-assessment plan for ARs to assess how far their approach to regulation is fit for purpose.

2. **Executive Summary**

a) The LSB, in overseeing effective regulation in line with better regulation principles and the regulatory objectives, has certain duties regarding amendments to regulatory arrangements, approval of new AR/LAs and extending reserved activities of existing AR/LAs.

b) Historically the regulators have regulated in the tradition of self regulation: high entry hurdles; single code of conduct/ethics focused on the individual lawyer; uniform business models and exclusion of non-lawyers. Historically there has been little by way of risk profiling and supervision of higher risk firms or individuals across much of the sector.

c) Competitive and commercial pressures along with the extension in the volume and complexity of the law have been undermining this approach for many years with legal services businesses already far removed from a single notion of a legal services profession. Huge partnerships have emerged since the late 1960s; sets of chambers increasingly behave and are treated as business units; consumers have become increasingly demanding; technology has led to massive changes in both firm structure and delivery models; and public expectation of professions and regulation has evolved. The transformation in ownership and management that the Legal Services Act 2007 (**the Act**) heralds will only intensify these developments.

d) The regulatory approach must move on from the self regulatory model. It needs to be able to regulate a wider range of businesses operating in a more diversified manner with increasingly diverse client profiles and presenting hugely varied risk profiles. This is a clear shift towards entity-based regulation, though not an abandonment of individual responsibility or regulation.

e) The LSB has already made clear its expectation of an outcomes-based approach to regulation in defining its approach to approving LAs. Solicitors Regulation

Authority (**SRA**) and Council for Licensed Conveyancers (**CLC**) are embracing these changes and some other regulators are starting to consider how best to regulate in a modern legal services market. But the LSB has not set out clearly the level of its expectations or the rationale for them, beyond the recent consultation on the draft Business Plan 2011/12.

f) This paper sets out the case for the LSB requiring regulators to raise their game and reach agreed standards in relation to outcomes-based regulation; having a framework for identifying and assessing risk to the regulatory objectives; having the capability and capacity to supervise according to those risks; and working to a clear enforcement strategy that both deters and punishes transgression.

g) The consequences of this development are that the LSB must make clearer its specific expectations of regulators in respect of the LSB's approval processes/regulatory decision-making. This will be achieved through amendments to processes and rules as appropriate. If the LSB is not sufficiently clear in setting out its expectations, we may find ourselves unable to take enforcement action where ARs do not deliver.

h) However, the aim should be to achieve these goals through persuasion. So the progress ARs make towards this model of regulation should be assessed through a self-assessment and capability/capacity reviews as part of the thematic or regulatory review process, rather than through formal regulatory action if at all possible.

What is the issue that needs to be addressed?

3. Much of the work that we have done in the 12 months since assuming our full powers has been about developing our policy approach to issues. We have also started to deliver the regulatory part of our role, making decisions on applications to change regulatory arrangements and starting to consider applications for new reserved legal activity designations and preparing for LAs. In future we may be required to approve new entrants.

4. Through this work we make clear the approaches and standards that ARs are expected to deliver. This has allowed us to promote outcomes-focused regulation and explain our expectations in terms of supervision and monitoring of authorised firms and individuals. We have seen some developments, notably the new codes of conduct developed by the SRA, CLC and Institute of Legal Executives (**IPS**).

5. But as more of this type of work is completed there is a risk that some of the existing ARs do not develop as quickly and will continue to operate over a sustained time on a more prescriptive rules-based approach.

6. To avoid a "two-tiered" regime we need to develop a mechanism which will bring those ARs that were "grandfathered" under the Act within the regime and to the required standards and so achieving consistency across the ARs.

Introduction – what is the role of the Legal Services Board?

7. The LSB does not directly regulate legal services providers but offers regulatory oversight to the ARs variously charged with that role for different and overlapping sections of the legal services market.

8. Section 3 of the the Act imposes an obligation on the LSB to act in a way that is compatible with the eight regulatory objectives and to operate in the most appropriate way for achieving those objectives. The same obligations are imposed on ARs.

9. The Act also requires the LSB to assist in the maintenance and development of standards of "the regulation by approved regulators of persons authorised by them to carry on reserved legal activities" (s4 (b)).

10. The LSB has set out its objectives and processes in previous consultations, rules and business plans. These combine reactive processes that meet our obligations to consider certain applications; proactive interventions that will support the regulatory objectives such as opening up the legal services market through allowing alternative business structures (**ABS**); and strategic interventions that provide a (more or less prescriptive) context for regulators to develop their own approaches to certain regulatory objectives such as diversity. These different approaches come together in three areas of our work:

    - Approving new ARs or LAs
    - Approving the extension of reserved activities regulated by any existing AR or LA
    - Approving new and amended regulatory arrangements.

11. So far our approach has been evolutionary. We have set high level rules for these processes where the Act requires and have focused these on outcomes rather than prescription where we consider that can best deliver freedom for regulators to design their own approaches to regulation that are compatible with the regulatory objectives and better regulation principles. That evolutionary approach has been effective since January 2010 and we expect that it will continue. But evolution is built upon change and we expect our evolution to be built upon our learning from experience.
    As the Board will recall from previous discussions, in our draft Business Plan 2011/12 we say:

> *"It is increasingly clear to us that there are four core elements to effective regulation of the legal services market:*
>
> - *An outcomes-driven approach to regulation that gives the correct incentives for ethical behaviour and has effect right across the increasingly plural and diverse market;*
> - *A robust understanding of the risks to consumers associated with legal practice and the ability to profile the regulated community according to the level of risk;*
> - *Supervision of the regulated community at entity and individual level according to the risk presented; and,*
> - *A compliance and enforcement approach that deters and punishes appropriately.*

We would welcome views on the appropriateness of these as the four pillars of regulation in order to further develop our thinking ahead of the final business plan."

12. This paper explores further that section of the draft Business Plan and sets out in more detail the LSB's emerging expectations and the rationale for enhanced requirements. After the closure of the consultation on our draft Business Plan, it is likely to lead to a consultation to amend certain of our rules for considering applications (such as: approval of amendments to regulatory arrangements; approval of new ARs and LAs; and extension of existing AR/LA approved reserved activities). This change may be achieved by detailed amendment to those rules or, alternatively, by the addition of a single clause requiring applicants to set out how they comply with any LSB policy statement made under s49 of the Act along with a new policy statement based upon this paper. Further analysis is being undertaken of the most effective route, subject to the Board agreeing the overall direction.

13. At this stage, the Board is asked to discuss and consider the issues raised in the paper so as to provide the Executive with a clear steer as to its appetite for demanding change in regulatory approaches.

Changing context for legal services and thus regulation

14. Professional self regulation has much strength. It is through professional adoption of regulatory standards that client confidence in goods and services has been built. That has led to the legal services market growing substantially over a sustained period and it remains for many a profitable business with many satisfied consumers. But professional self regulation is recognised as unlikely to focus on efficiency and equity (or alternatively unlikely to correct producer/consumer asymmetry), rather it supports a market to grow to its most profitable size. This is explored more fully in the Regulatory Policy Institute (Decker and Yarrow) paper, *Understanding the economic rationale for legal services regulation*, Chapter 5 – The supply structure of legal services[1].

15. Self regulation has achieved this through a focus on high hurdles for entry; originally based upon an apprenticeship model but increasingly based upon education and qualification models. Alongside those high entry standards, a common code of ethics or behaviour was put in place that gave consumers confidence about how their professional provider would behave. Any professional that did not adhere to the professional code of conduct faced punishment or exclusion.

16. The self regulatory model emerged and developed more or less as part of a homogenous legal services profession. There has historically been a single way of practicing law as a solicitor or barrister. That encompassed firms or chambers being remarkably similar in their structure, evolution, working practices and delivery models. The self regulatory model has the profession in control: in control of entry, standards of delivery, professional and firm behaviour, firm structure, external involvement and often even controlling prices. It is a truly vocational model of delivering professional services and not a model that is primarily designed for achieving a return on capital.

[1] A copy of this paper is attached to **Paper (11) 04**.

17. However, commercial and competitive pressures have grown over the last 50 or more years. Removal of the limit of the number of partners in a law firm in the Companies Act 1967 sealed the fate of any idea of a uniform professional services firm structure. Since then the number of partners in some firms has grown seemingly exponentially and with that the business models, structures and practices have varied similarly.

18. It is not just firm size that has led to an increasing plurality amongst legal services businesses over several decades. Technological capacity has grown across the economy and some law firms have embraced this in their business management process and consumer delivery models. Many others have not and remain sceptical of the commercial value in large scale investment. Perhaps linked to improvements in communications technology and certainly reflecting the needs and business models of their consumers, many law firms have grown to become international, whilst others remain small or rooted in local communities.

19. It may be that greater entrepreneurialism within the legal profession has meant some firms are more open to different ways of working or different opportunities, but we can be sure that law firms look less like each other now than they did 50 years ago.

20. There is also no doubt that the current recession has further intensified commercial and competitive pressures. For example, the enfeebled housing market impacts not just on standard conveyance transactions but also on re-mortgages, new builds and buy-to-let. As much as 50% of many small firms' work has been related to the housing market.

21. This pressure on revenue has been replicated in other areas such as commercial work at the mid-market and corporate end - evidenced by large lay-offs in some firms, mergers and even collapse and closure of some firms.

22. Perhaps as evidence that no sector of the legal services market remains untouched we can see recent and planned changes to legal aid as continuing the intense pressure on the legal services sector. Combine a perceived lack of investment in technology, very small firms and hugely fragmented services with a political desire to reduce expenditure, and we have unfolding perhaps the largest upheaval to legal aid providers in their 60-year history.

23. Across the wider legal sector, the hit on revenue has also been significant due to the recession. Add to that a reduction in the availability of bank finance and a reduction in capital in the insurance sector, and it is no surprise that consolidation, restructuring and plurality are the pre-eminent themes that have been discussed. And it is not just the solicitor and conveyancer sector that is changing. Legal aid changes are impacting on the Bar similarly and the search for greater value by other consumers is having a similar impact on those law businesses working with private business and other public sector bodies.

24. The Bar is having to consider historic changes to practice models to gain work in criminal prosecution and defence; to establish panels and procurement companies for local government; and to compete as chambers rather than individual barristers for much private work.

25. The impact of greater consumer empowerment is perhaps most visible at the larger end of the legal services market where outsourcing and off-shoring gain tentative holds in the foothills of legal services. This is not just about other types of law firm being able to do some parts of a more expensive firms work more cheaply. A recognition that much corporate work is not actually reserved to lawyers is opening parts of the market to new types of business not owned or managed by lawyers. The twin influence of corporate counsel and both central and local government as bulk purchasers may be the emerging driver of much change in the legal services market.

26. Of course the regulated providers have always been open to potential competition on non-reserved services from non-lawyer owned businesses. In some areas such as will writing and tax planning in-roads into the legal market have been made by non-lawyers. But in most legal services external competitive pressure has remained latent as lawyers were barred from offering services to the public if working in a non-lawyer owned business and the public continued to value the solicitor brand. To date the commercial impact has been limited but the increasing opportunities that technology offers in legal services provision have seen some recent changes. On-line legal services are now growing as large businesses with the capital to invest, the brands to connect with consumers and the client flows are able to cross sell.

27. The arrival of ABS is likely to sharpen the focus on unreserved services. An ABS must deliver reserved legal services and as such any potential entrant will carefully weigh both the services it needs to deliver to meet consumer demand and the cost of regulation. Whichever way new entrants jump, the competitive pressures are likely to increase.

28. Inevitably the focus is on large scale consumer facing legal services – corporate and personal legal services. But the advent of multi-disciplinary practices and ABS makes any notion of one section of the legal services market remaining unaffected unlikely. From cost lawyers to patent and trade mark attorneys it is inconceivable that they can exist in separate silos. Already the majority of licensed conveyancers and legal executives work in multi-legal businesses; other parts of the profession are similarly seeing boundaries disappear. Equally, from tax planning and business advice to personal financial advice, the historic regulatory regime has perhaps stifled law firms moving beyond pure legal advice into broader advisory services.

29. This changing context for legal services can best be summed up as a gradual move away from a homogenous profession towards an increasingly plural legal services market. If the trend continues to grow and accelerate because of the combination of lower barriers to entry (for capital) and increasing potential from technology then we can expect greater and faster change in the future.

30. The Act, and thus the LSB, is primarily focused on deregulation, in that it removes anti-competitive regulatory barriers to ownership. The LSB, like Parliament before it, sees this as a positive contribution to innovation, access to justice, choice and thus consumer benefit. But the Act is not about complete deregulation (if it were it would be a lot shorter than its magnificent 387 pages). Protections are intended against long-standing risks and new risks that attach to deregulation. These include some legislative bulwarks (such as fitness to own tests) but legislation is a blunt instrument

because it can only deal with the most egregious of threats and is hardly dynamic. Thus the need for regulatory practice to change as well is imperative.

31. What is clear is that, as the legal services market has changed, the risks that it presents to the public and consumer have changed. Some might highlight the miners' compensation cases as evidence of increased problems or perhaps of the visibility and impact of poor behaviour when on a large scale. Others might stress that the commercial and competitive pressures have increased the threat to consumers. Regulation of course must be able to identify the real risks and regulate in a manner that keeps pace, encourages, supports and controls these changes so as to underpin the regulatory objectives. In the following section we explore what sort of regulation may be fit for purpose.

What sort of regulation does the LSB expect from ARs?

Outcomes-focused regulation

32. The LSB has already nailed its colours to the mast of outcomes-focused regulation (**OFR**). In agreeing the SRA's approach to becoming an LA, the LSB ensured that a shift towards OFR was made at the same time. Similarly CLC and IPS are moving towards the establishment of clear outcomes. These are important steps away from the permissive approach that prevents all behaviour unless it is shown to be safe. An outcomes-based approach combines flexibility, responsibility and accountability for legal services providers – it is they that must secure the regulatory outcomes and decide how their firm will do so. We do not under-estimate the scale of change required from both ARs and the regulated community.

33. For regulators OFR is crucial in as much as it recognises the plurality that has emerged in the legal services market. It would be resource intensive if not impossible to design a set of detailed rules that works for each and every type of firm. As has been seen in recent years with solicitor conflict rules, a one size approach has simply not coped with the developing business structures and practice in conveyancing, corporate work and elsewhere.

34. The pursuit of outcomes is part of the shift towards a consumer focus. Ensuring regulation is focused on consumers must be based upon a proper understanding of consumers and their expectations. The LSB's work on consumer outcomes will provide a foundation for the whole sector but that will need to be complemented with sector specific work to identify appropriate outcomes for each regulator.

35. In setting outcomes, the ARs must go further than simply consumer expectations. Regulation does not put restrictions on business simply because consumers prefer it; rather it exists to protect certain outcomes that Government, Parliament and, in the case of legal services, the Judiciary decide warrant protection. Thus the regulatory objectives in their entirety need to be reflected in the outcomes upon which regulation is based. Regulators must show the basis and evidence upon which their outcomes are set.

36. An outcomes-based approach, with responsibility for compliance falling on the regulated community, is not a pure deregulatory approach. The Act provides very

clear boundaries in terms of the regulatory objectives at the highest level and more detailed prescription elsewhere (such as ownership of ABS).

Risk identification framework

37. Once the regulated community has freedom to operate in the manner it chooses to deliver compliance with the outcomes-based codes, it becomes increasingly important that the regulator focuses on the parts of the regulated community that present the greatest risk to the outcomes. As we have explored earlier, in a changing market the plurality of business and delivery models means that risk is neither evenly spread nor fixed. A risk-based approach helps regulators move ahead of the curve – away from writing rules for things that have already happened and closer to mitigating risk.

38. The changing nature and increasing plurality in the legal services market is probably the biggest driver towards entity-based regulation. The Board considered some aspects of this at its September away day and, whilst acknowledging the need for entity-based regulation, was mindful not simply to abandon the individual responsibility that is at the core of a profession.

39. Regulators will need to show that they have a framework in place for identifying risk. This will operate at the level of the overall regulated community; different business, ownership and management structures; financial issues and size of entity or firm; individual practitioners; consumer segments; workforce skills, knowledge and experience; and other factors as appropriate. They will need to update this regularly and have systems for identifying trends and changes in the risks.

40. In addition to the identification of risks themselves, ARs must have systems for profiling each regulated entity and tracking changes in risk profile over time. Again, this will need to operate at the individual, entity and thematic level to properly and proportionately capture and mitigate risk.

41. Such an approach will allow ARs to ensure that regulation remains proportionate to actual risk within a plural and diverse market.

Proportionate supervision

42. Having a clear and evidence-based risk system allows a regulator to target resources on those businesses, individuals, sectors and issues that present the greatest risk to the regulatory objectives and consumer-focused outcomes. That, combined with the duty across all of the regulatory community to take responsibility for their own compliance, shifts the focus of regulatory activity away from compliance with detailed rules towards supervision of the most significant risks.

43. For this to be effective, ARs must be able to profile the regulated community – and regulated activities – by risk and group accordingly. A high risk firm is not necessarily one that is doing something wrong – it simply means that the likelihood of a breach of outcomes is higher or more significant. Thus a firm that is facing financial challenges may be high risk alongside a firm that is working only with highly vulnerable consumers. ARs will need to make clear that they do not seek to make the regulated community only low risk – rather they accept that innovation, change

and certain types of work carry greater risks that warrant closer supervision in order to make them safe for consumers. This benefits firms as it builds consumer confidence in those areas that are perceived as higher risk.

44. The parts of the regulated community that are profiled as lower risk should benefit from less intensive supervision. But, of course, they will have no greater or lesser freedom to deliver services that do not compromise the regulatory outcomes and the duty to remain compliant with the specified outcomes will act as a boundary for those firms. Even without close supervision, they are unlikely (especially so given that they are classed as lower risk) to transgress – that is the nature of being lower risk – but an effective enforcement strategy should assist in those businesses living up their low risk categorisation.

45. Firms set culture, process and direction for individual staff. Thus supervision of the regulated community must operate at the entity level as well as the individual. It will be for the AR to decide the appropriate balance between entity and individual supervision based upon the actual risks.

46. A supervisory regime must operate at the authorisation stage as well as providing ongoing supervision. This may be through education and qualification requirements for individuals through to any number of factors for entities such as financial stability, insurance requirements or transparency of ownership.

47. ARs will therefore need to demonstrate not just systems and process but also capacity and capability to supervise effectively. This will include demonstrating that they have financial resources to secure and maintain adequate people, systems and controls.

Appropriate enforcement strategy

48. Of course no regulatory approach can guarantee that the whole regulated community will continue to operate without error or transgression. Regulators therefore must have an enforcement strategy that incentivises and encourages compliance; deters non-compliance; and punishes transgressions appropriately.

49. Such a strategy cannot simply be directly proportionate. To deter, the threat of punishment has to be (to some degree) disproportionate: there is little point in fining someone £100k for a £100k transgression – it is worth the risk, as there is little to lose. Similarly, the strategy must cater for a range of effective sanctions that serve as punishment. The punishment in any particular case should be capable of acting as a deterrent to the wider regulated community so as to feed back into better compliance. This suggests that some degree of transparency is required.

50. To be effective the enforcement process must be flexible. Thus it needs to be capable of moving quickly and retaining its focus on high quality investigation and decision-making. It should also be able to address issues at entity and individual levels as appropriate.

51. The LSB also expects that the enforcement strategy must provide effective redress direct to those directly harmed by the behaviour that is being dealt with. Consumers will take little confidence from knowing that other consumers will not be harmed –

they rightfully expect regulation to protect them from misuse of the imbalance in knowledge and power.

52. For enforcement to build confidence amongst all stakeholders it must be credible – that is simple, fair, speedy and summary where appropriate.

Implementation

53. ARs must ensure that there is effective translation of all the above into regulatory operations. As oversight regulator, the LSB will expect ARs/LAs to demonstrate that it is happening in practice – and having a demonstrable effect on behaviour and/or public confidence as appropriate.

54. The detail of how to implement is a matter for each AR/LA. The LSB recognises that not each AR/LA will regulate the same set or range of risks, so the regulatory framework for each AR/LA will vary. Therefore each will need a different mix of supervisory tools depending upon the nature of the market and risks that are being regulated; but implementation has to be based upon the obligation to deliver the regulatory objectives rather than any professional preference.

55. It is appropriate, and consistent with the better regulation principle of transparency, that we give a clear indication to applicants on what they need to include in submissions. Where appropriate, we would match this with statutory guidance to existing bodies.

56. These proposals have been informed by the LSB's experience of regulatory decision-making during 2010 and from its ongoing consideration of applications made or being prepared (such as IPS' applications to extend reserved activities and SRA's LA application). In effect these are emerging as part of our regulatory decision-making but have not been set out as explicit criteria.

57. It is proposed that the standards in this paper should be further developed and phased in over a 12-month period. That would allow them to be used to support decision-making in existing applications without being an unfair late addition to the rules. It would also allow ARs that have not yet embraced this approach time to move towards better regulation.

58. To assist this, the Executive proposes, once the overall approach has been settled, to invite each AR to conduct a simple self-assessment of its regulatory approach against this high level model (although there would be no objection should one of the ARs wish to inject some external scrutiny into the process). That would then be the basis for a supervisory discussion between LSB and each AR, consistent with LSB's role as overseer rather than direct regulator, leading to an agreed action plan for the AR to develop its own regulatory model.

59. The LSB will use its approval processes to encourage and ensure compliance. Thus any AR making an application to amend its regulatory arrangements, extend its reserved activities, become an LA, or indeed enter as a regulator for the first time, would need to show how it met the LSB's expectations.

What do ARs gain from this approach?

60. There are a number of potential benefits to ARs from this approach:

- More clarity from LSB on what it expects from ARs – plan accordingly rather than deal with issues as they arise
- LSB should develop more confidence in their ability/effectiveness as a regulator – which should lead to less intrusion/questioning and ultimately reduce the risk of LSB intervention (subject to standards being maintained and reported on)
- Effective forward-looking risk assessment – ARs can (and will be seen to) take appropriate action to mitigate against the big risks actually occurring
- Take action – less risk to individual consumers; increased confidence
- Outcomes-focused codes – less prescriptive rules; less need to change them as circumstance change; reduced need for LSB approval
- Overall a body of evidence will develop from which assurance can be gained as to the effectiveness of legal services regulation.

What are the risks in shifting expectations?

61. The following uncertainties and potential risks have been identified so far:

- Do the ARs have the ability to deliver?
- What is the cost to ARs (and the regulated communities) of modernising regulation?
- Are the benefits greater than the costs?
- What impact would this change have on ARs' other priorities?

62. We believe that these issues can only be effectively addressed by beginning a process of open discussion based on a refined version of this paper.

How well would ARs fare in a self-assessment exercise at present?

63. It would be wrong to draw any certain assessments at this stage. However, we can tentatively make some initial hypotheses.

64. The SRA has firmly and clearly set out its move towards a regulatory model resembling that set out in this paper. It acknowledges that the journey is much more than re-writing codes: it includes a fundamental re-appraisal of the relationship with each regulated entity and individual and the evidence upon which that relationship is based.

65. The Bar Standards Board remains a rules-based and permissions-based regulator. It is considering entity regulation and new business models, recognising the need for a different regulatory capacity and capability as it changes.

66. CLC and IPS are committed to an outcomes-based model. Whilst we do not have clear visibility yet on CLC's approach to regulation, nor its underlying capacity and capability, we will better understand that as its imminent applications to extend reserved activities and become an LA are processed. IPS is currently being assessed and the core elements of this paper have been discussed with its Chair

and Chief Executive. They acknowledge that they are at the very start of their journey.

67. The smallest regulators are beginning to engage with these issues and consider how best they can regulate. On current evidence, none is close to this model of regulation at present. The research that has been completed by Nick Smedley on smaller ARs will be a helpful start point for these ARs when they consider the self-assessment.

Engaging with ARs

68. For this to be successful within a reasonable timescale it will need commitment from all of the ARs. While enforcement is one means by which the outcome might be achieved, we believe that early and proper engagement with the ARs should allow us to develop an approach that they are willing to support and therefore has greater chance of being implemented; the progress that has been made so far has been achieved through open and robust dialogue. We propose to start this process by sharing with the ARs this paper, providing the opportunity to explain our approach and seek their input.

Conclusion

69. With ARs in some state of flux as they respond to the Act, it would appear that we have a unique opportunity to embed better regulation principles. The pace of change in the legal services market is unlikely to slow and the resulting plurality of business structures and service delivery is unlikely to reduce. The Executive considers that the time is right for the LSB to set out a baseline approach to regulation and review ARs' performance against those standards.

Next steps

70. On agreement by the Board of this approach, the next steps will be:

- to share a revised version of this paper with the ARs to stimulate debate and support the draft Business Plan
- following that engagement, to set out in more detail our expectations
- to review our own existing rules, procedures and guidance and, if required, consult on changes to support the delivery of the new approach
- to consider and agree the self-assessment process including how compliance will be measured and non-compliance enforced
- the proposed initial timetable is for ARs to complete self-assessment by the end of October 2011 and LSB to review and report on the submissions by the end of March 2012, but we would keep this under review as the project progresses. While the process should not be long delayed, more time in development to ensure greater support may prove beneficial in the medium-term.

ANNEX A

Key indicators of, or criteria for, regulatory excellence

Outcomes-focused regulation

- Outcomes-based code / requirements which are focused on outcomes for consumers / are consumer facing
- Recognise public interest in legal services as part of wider justice system
- Reduced / little mandatory guidance; guidance should not unnecessarily restrict firms in how they deliver the outcomes
- Set education and training standards both at entry and on an ongoing basis
- Set/describe practising standards
- Focus on entity as well as individuals
- Effective advisory services for regulated entities and individuals.

Risk assessment

- Formalised approach to risk assessment which is transparent
- Responsive to changing conditions
- Collection of data set and other information to determine the risk assessment
- Should be capable of picking up individual and firm specific as well as wider profession issues
- Forward looking as well as assessing risks from current data
- Outputs determine supervision activity – themes, intensity, frequency, form.

Supervision

- Activity determined by risk assessment outputs
- Proactive as well as (more than?) reactive
- Forward looking plan of activity – focused on risks; flexible; report on progress against the plan, findings and issues
- Responsive to changing conditions
- Thematic as well as firm specific.

Enforcement

- Predominantly targeted at breaches that are serious and undermine regulatory objectives (perhaps alongside a set of more administrative penalties)
- Incentivises and encourages compliance
- Fast and fair
- Deterrent as well a punishment
- Appeals process
- Publicity (important for deterrence)
- Enforcement policy that sets out the approach.

Capacity and capability of ARs to deliver regulatory excellence

- Clear understanding of the different areas that regulator responsible for
- Number of people needed – maybe linked to the number of people / firms to be supervised; do they have enough for what they need to do
- Type of people – skill sets; role profiles

- Underlying governance processes, systems and controls – how will they deliver the various functions; do they know what they need to do; (independent) assessment of effectiveness; compliance with IGRs
- Effective Board, challenging and holding Executive to account, whilst defending regulatory independence.