

To:	Legal Services Board	
Date of Meeting:	30 April 2013	Item: Paper (13) 23

Title:	Cost and complexity of regulation	
Workstream(s):	Workstream B (see Business Plan 2013/124)	
Author / Introduced by:	Chris Handford Chris.handford@legalservicesboard.org.uk / 020 7271 7004 Alex Roy / Fran Gillon	
Status:	Unclassified	

Summary:

In our 2013/14 business plan and the response to the Triennial Review, the LSB committed to review the costs of all legal services regulation and its impact on the regulated community. We said that we also attempt to understand the underlying causes for costs and the impact that the complex legislation underpinning the regulatory framework, the approach of regulators and the perceptions of the regulated community have on the costs burden. The results are expected to inform a simplification project if areas of potential reform are identified.

The aim of the project is to test the hypothesis that the system is too complex, not risk based and thus drives higher costs than are necessary for delivery of regulatory objectives in line with better regulation principles.

This is in effect another way of looking at *what* should be regulated and *how* it should be regulated that was started with our July 2011 discussion document: “Enhancing consumer protection, reducing regulatory restrictions – A discussion document about how the LSB will assess the boundaries of legal services regulation and connected regulatory decisions¹”.

This paper sets out the context for this work and the Executive’s planned methodology.

Recommendation(s):

The Board is invited:

1. to note and comment
2. to identify any perceived gaps in or necessary additions to the workstream.

Risks and mitigations

Financial: N/A

Legal: N/A

¹http://www.legalservicesboard.org.uk/what_we_do/consultations/open/pdf/enhancing_consumer_protection_reducing_restrictions_final_28072011x.pdf

Reputational: N/A
Resource: Recruitment underway for project associate

Consultation	Yes	No	Who / why?
Board Members:	X		Terry Babbs, Steve Green, Bill Moyes, Barbara Saunders
Consumer Panel:		X	Draft shared and high level approach discussed with Panel Manager
Others:			

Freedom of Information Act 2000 (Fol)		
Para ref	Fol exemption and summary	Expires
Para 7, last sentence and footnote 4	Section 44 - restricted information obtained by the Board in the exercise of its functions [and therefore] must not be disclosed (s167 LSA)	

LEGAL SERVICES BOARD

To:	Legal Services Board		
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Cost and complexity of regulation

Context

1. The Legal Services Act 2007 (“the Act”) established the LSB to oversee the reform of legal services regulation in England and Wales (*in the consumer and public interest*). We have made real progress with all of our key priorities to date:
 - a. ensuring that the regulatory arms of the approved regulators are structurally independent of their representative arms
 - b. liberalising the marketplace including through the introduction of alternative business structures and greater innovation in the delivery of legal services
 - c. improving the complaints system for consumers
 - d. improving the effectiveness of the front-line regulators.
2. However, much of the regulatory architecture² that was in place prior to the introduction of the Act remains in place today. The patterns of which legal services are regulated, the existing approved regulators, the approved regulators’ regulatory arrangements and the legislative authorities that underpin them were largely carried over with the Act. There has been no proper assessment by the front line regulators of their arrangements and approach against the regulatory objectives, the better regulation principles, the needs of consumers in the current market place or any other public interest test or legal principle. There has been no comparison of the cost imposed by regulation with the benefits that they deliver. The LSB’s powers and tools for micro level assessment and approval are quite limited unless the LSB were to take the view that it should grow substantially in order to challenge regulators rule by rule. This is clearly not a tenable position.
3. This has left a regulatory landscape that is multi-layered and complex. For example:

² Described by Sir David Clementi in his 2004 independent Review of the Regulatory Framework for Legal Services in England and Wales as a “regulatory maze” “resulting in a landscape punctuated with gaps, overlaps and anomalies”

- a. The LSB oversees ten approved regulators³ each with its own codes, rulebooks and approach to regulation. Some regulate the same activities in different ways.
 - b. The legislative underpinning for individual approved regulators was not consolidated within the Act. There is different legislative underpinning for different regulations and different regulators and no legislative underpinning for others. The current regulatory framework stretches to at least 7 main statutes and a very large number of statutory instruments.
 - c. There are six reserved legal activities that may only be undertaken by individuals and entities authorised and regulated by an appropriate approved regulator. However, many traditionally recognised lawyers are regulated in the same way for all of the legal activity that they undertake, reserved and unreserved, by virtue of their professional title and regulators' rules, although they increasingly face competition from those who do not have such requirements.
4. There are direct costs associated with these structures. Many respondents to the triennial review questioned the £4.5 million annual cost of the LSB and also the costs of the Office for Legal Complaints, which are levied from the profession. Concerns were also raised about the resource and opportunity costs associated with the LSB's oversight role, for example: approving rule changes, approving practising fee levels, monitoring and enforcing internal governance rules designed to ensure that regulatory functions are carried out independently from representative functions and monitoring regulatory performance. However, these are but one small part of the total costs that practitioners have to bear in order to practise.
 5. Practitioners clearly have to bear the financial cost of practising fees. More importantly, however, the main cost faced by practitioners on the ground is the resource and opportunity costs of complying with the rules and regulations set by their approved regulator. Every rule and regulation imposes a compliance cost on business. This includes providing data to demonstrate compliance. Good businesses may have to put in place systems and processes to deliver the intended outcome of many requirements, irrespective of regulation, for example, education and training requirements, professional indemnity insurance requirements and client care requirements. However, regulatory prescription can increase costs. Regulation can hamper the ability of a business to organise itself in the way that it thinks will best maximise its competitiveness and growth and to deliver the services in the way clients

³ This includes the Institute of Chartered Accountants in Scotland and Association of Chartered Certified Accountants who are approved regulators for probate activities only but do not currently authorise anyone to offer this service.

want. Therefore, it is essential that regulatory arrangements are proportionate and targeted at risk.

6. There is a prima facie case that the transfer of existing regulatory arrangements and underpinning legislation maintained an institutional and cultural legacy of professional self-regulation that adds costs and creates barriers to change and innovation. To the extent that this sets the cultural tone of the market, it may act as a barrier to new entry, even if new entrants may not be directly caught by the regulation. It certainly could constrain existing players from responding as flexibly as they may wish to do to the challenge of entry.
7. The Act named the existing professional bodies as approved regulators. Practising fees include a compulsory levy for permitted purposes undertaken by the professional body on top of the costs of the regulatory body. Permissions from the professional body are still required by regulatory arms to make certain constitutional and other changes. Underpinning statutes such as the Solicitors Act 1974 enshrines an emphasis on the regulation of individuals with different titles rather than of authorised persons undertaking reserved legal activities. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]⁴.
8. It appears that many regulators currently view each new risk and each new market development through the prism of authorising and maintaining the standards of individuals that have qualified as, for example, solicitors or barristers. Mixed service provision, innovative delivery methods and risk management processes not focused on work being delivered or supervised by a qualified individual member of the profession are often eyed with suspicion. It can be argued that this results in restrictions on business and an inflexible, over-cautious, permissions based regulatory approach. This is highlighted by, for example:
 - a. the SRA's lengthy alternative business structure application process
 - b. the Bar Standard Board's comparative lack of progress with entity regulation
 - c. the default extension of regulation to all the work that regulated practitioners undertake including non-reserved work. Rules prevent the

⁴ [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

construction of connected businesses providing unreserved activities outside of regulation. Together this prevents competition on an equal footing with unregulated providers delivering unreserved legal services.

- d. the default application of the full range of general practice requirements to regulated practitioners, based on the risk that any member of the profession could present in theory rather than the actual risks presented by different businesses
 - e. the common practice of regulators in considering (and granting) requests for waivers from detailed requirements, rather than using that evidence to question the rationale for a blanket requirement.
9. Counsel's advice (and practical experience) provides that the 2007 Act does not in itself give approved regulators the powers necessary to meet all the requirements of the regulatory arrangements required by it⁵. Therefore, primary or secondary legislation is required if regulators do not have appropriate power in their own constitutional or statutory framework for the arrangements that they require. Identifying relevant authorities and gaps, drafting legislation and the Parliamentary process is costly and complex. This is likely to cause problems with any attempt to harmonise arrangements, for example to create efficiencies in the disciplinary and appeals processes by all regulators using the same appeal mechanism⁶. Moreover, this provides a disincentive for regulators to modernise their arrangements and prevents regulatory arrangements moving at market speed. A particular barrier is presented to potential new regulators, without a history of statutory regulation or charter, seeking designation as regulator, for example a trade body wishing to regulate non-lawyer will-writing firms should this become a reserved legal activity.
10. Prescription within the Act does, however, create significant hurdles that must be overcome in order to enter or invest in the legal services market, particularly as an Alternative Business Structure ("ABS"). Schedule 11 consists of eight pages prescribing procedural and structural requirements for ABS. Schedule 13 consists of 21 pages prescribing the process by which a licensing authority must consider whether a non-lawyer should be allowed to own an ABS. This is not risk based and presents significant costs. It assumes that ABS are more risky than other types of law firm (when there is no evidence that they are). A small law firm adding a wife or husband as a non-lawyer owner to create an ABS is treated as inherently more risky than a major traditional law firm partnership or LLP being restructured into a new entity to avoid intervention and liquidation. The Office of Fair Trading recently

⁵ Listed at Section 21 for approved regulators and Section 83 for licensing authorities.

⁶ IPREG are currently experiencing this problem, they do not think that they have the statutory authority for appeals as an approved regulator to be heard by the General Regulatory Chamber.

estimated that on average it costs an ABS between £27,000 and £160, 000 more (depending on size) to be authorised than a traditional law firm.

Why us, why now

11. The aim of the project is to test the hypothesis that the system is too complex, not risk based and thus drives higher costs than are necessary for delivery of regulatory objectives in line with better regulation principles.
12. The Triennial Review, business plan consultations and discussions with existing and potential providers have all highlighted a widely shared view that the current system is sub-optimal both in terms of effectiveness and costs. This reflects the LSB's own experience. The LSB along with the regulators have a duty to meet the regulatory objectives in line with the better regulation principles. As the oversight regulator, the LSB has a role to play in undertaking a fundamental review of the entire regulatory landscape that approved regulators restrained to their own segment of the market are not able to do.
13. We are particularly concerned that unnecessary costs and complexity in the current system may be having negative impact on the regulatory objectives of:
 - a. promoting competition within the provision of services
 - b. protecting and promoting the interests of consumers
 - c. improving access to justice
 - d. encouraging an independent, strong, diverse and effective legal profession.
14. This work may identify an optimal longer-term operating framework in preparation for the next triennial review. This would likely encourage and support entry, growth and innovation within the legal services market and therefore enable better access to affordable legal services to consumers. As a minimum this work will set a strategic context for securing the regulatory objectives and better regulation principles within the current framework. This will inform our on-going statutory decision making and other specified duties.
15. Our proposed methodology is set out below.

Stage 1: Risk Framework

16. The aim is to develop a framework of the core risks common to all types of legal activity that we are trying to tackle through legal services regulation. This would provide a conceptual starting point to support the analysis of existing regulation, ideal regulation and any proposals for change.

17. We do not intend to base the framework on risks to the full range of existing regulatory objectives but rather undertake an *a priori* review of the risks within a totally unregulated market that would likely prompt regulatory intervention.
18. The first action will be for the Project Team to develop a first draft. We will draw together salient aspects of existing research and literature, LSB commissioned and other, including that which informed our approach to assessing the boundaries of regulation and connected regulatory decisions⁷
This includes:
- a. Dr Decker and Professor Yarrow - paper on the Economic rationale for legal services regulation and accompanying essays⁸.
 - b. Professor Stephen Mayson and Olivia Marley (as the Legal Services Institute) – paper on the rationale for reserving legal activities⁹
 - c. Opinion Leader – research into what consumers want from regulation of the legal services market and what they expect from their interaction with legal services¹⁰
19. This will be informed by wider internal dialogue. An initial scoping of the problem facilitated by Professor Julia Black of the London School of Economics at a colleague development event proposed that primary risks might include protection of client money, quality of legal services and maintaining the smooth administration of justice and the wider rule of law.. This is consistent with the Decker and Yarrow paper for the LSB referenced above. It is likely that some further risks associated with the range of existing regulatory objectives will also feature within the framework
20. The framework will be further developed and checked through an external workshop (including consumer groups, professional bodies, regulators, academics and other interested parties).

Stage 2: Cost and complexity of regulation.

21. The aim is to understand the overall cost, proportionality and efficiency of legal services regulation. The stage has been split into two parts and a number of mini-projects within each part. Many of these projects, given the nature of the economic study, will be supported by externally commissioned research. The project streams and structure are set out in the diagram below

⁷ LSB, Enhancing Consumer protection, reducing regulatory restrictions, 2011:

http://www.legalservicesboard.org.uk/what_we_do/consultations/closed/pdf/6.pdf

⁸ Dr Christopher Decker and Professor George Yarrow, Regulatory Policy institute “Understanding the economic rationale for legal services regulation”, March <https://research.legalservicesboard.org.uk/wp-content/media/Why-regulate-legal-services-RPI-report.pdf>

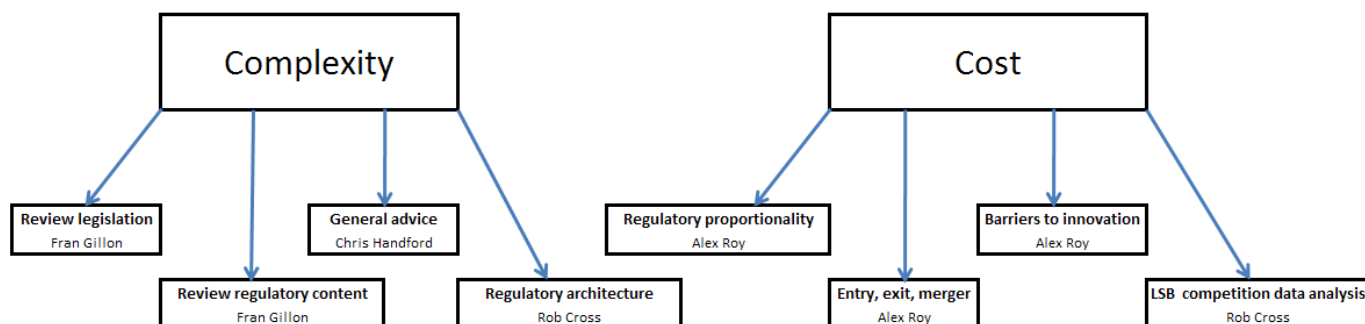
<https://research.legalservicesboard.org.uk/wp-content/media/Why-regulate-legal-services-essays.pdf>

⁹http://www.legalservicesinstitute.org.uk/LSI/LSI_Papers/Institute_Papers/The_Regulation_of_Legal_Services_What_is_the_Case_for_Reservation_/

¹⁰ <https://research.legalservicesboard.org.uk/wp-content/media/2011-Consumer-outcomes.pdf>

and further detail is set out at **Annex A**. Research is underway that will identify what data already exists to assist with reviewing regulatory proportionality and where further data is needed.

Fig.1: Cost and Complexity project components



Stage 2a: Complexity of regulation

22. We will review the framework’s legislative and regulatory structures. The output will be analysis and evidence of where the current complexity, inconsistencies, gaps and overlaps present structural barriers to better regulation, lead to sub-optimal consumer and regulatory outcomes and add unnecessary costs.

23. It is worth noting here that work to assess the scope of legal services regulation that the Board started in 2011 will now sit within this work-stream rather than as a stand-alone project¹¹. How and where regulation bites is the foundation of the regulatory framework and will be assessed against the risk framework. Research has previously established that there is no risk-based rationale for historical decisions about which activities are reserved and which anybody can deliver outside of regulation¹². Similarly, extending regulation and the full regulatory tool-kit to all the legal work, reserved or unreserved, of traditional lawyers in a similar way does not appear to be targeted at risk. The overall effect is to create regulatory asymmetry whereby protections for consumers and regulatory burdens for providers are determined by who delivers the service and not the risks involved.

24. This will include analysis of the costs imposed on the legal market by the LSB and the Legal Ombudsman – both direct and compliance costs. It will also include an assessment of the direct costs (and fees) of front-line regulators and of the non-regulatory permitted purposes.

¹¹ http://www.legalservicesboard.org.uk/Projects/reviewing_the_scope_of_regulation/index.htm

¹² Legal Services Institute, The Regulation of Legal Services: Reserved Legal Activities: History and Rationale, August 2010

Stage 2b: Cost of regulation

25. We will review the costs and benefits of *actual* regulatory arrangements as experienced by providers on the ground. This cannot be done other than by case study – taking priority or exemplar areas of regulation and seeking to understand their costs. The output will be evidence of specific regulations and costs which could be removed, reduced or better targeted – or possibly of areas where excess caution or “regulatory myth” is leading to over-engineering. Areas of regulation resulting in compliance costs will be prioritised for review. There will be a particular focus on regulation that has a negative or detrimental impact on the shape of the market.

Stage 3: Simplification

26. We will draw together the evidence and analysis of structural and regulatory challenges from Stage 2 and set out an ideal regulatory blueprint for proportionately addressing and mitigating the identified risks. We will identify whether there are any risks that are not being tackled and also map out regulatory structures that can be stripped out, simplified or improved to better align with the better regulation principles. The blueprint will include analysis of what should be regulated, who should regulate what, the structure and content of regulatory arrangements and the appropriate legislative underpinning.

27. There will be a further level of sophistication within the analysis distinguishing between the different risks presented within different segments of the market, for example corporate clients and individual consumers. It will be important to use the Oxera segmentation to analyse how the overall risks might vary within different segments¹³. This will not mean that the LSB assesses risk segment by segment, rather it provides a blueprint for doing so. That, alongside the regulatory toolkit that makes up the blueprint, will be the benchmark against which the current regulatory system can be analysed.

28. This will likely result in an evidenced narrative that in order to improve the ability of the sector to respond to dramatically changing market conditions the regulatory architecture must be simplified and quality of regulation within it improved in line with the better regulation principles.

Stage 4: Option development

29. The final stage will be to develop a range of options for delivering changes that may have been identified as being necessary or beneficial. It is impossible to say before the preceding stages have been undertaken how

¹³ <https://research.legalservicesboard.org.uk/news/marketsegmentation>

significant the recommended changes might be. Similarly we cannot predict the range of options that might be needed or appropriate. However, in theory they may include:

- a. a comprehensive rewrite, consolidation and simplification of the legislation, this would likely to be slow to deliver and need the widest buy-in to deliver at all
- b. the least radical option would include marginal improvements within the current system – using existing LSB powers and regulator commitment to deliver incremental improvements
- c. there may be other options in-between such as using amending powers to existing regulation and legislation such as secondary orders under section 69 of the Act.

Project development and timetable

30. The Executive will develop a project initiation document and plan to bring together all the different strands within this work-stream. The aim would be to have the options paper and all supporting evidence and analysis published by the end of 2014. This would be well timed to inform the next LSB triennial review. The options will be designed to provide the analysis and flexibility to allow any incoming Government to identify an option that fits its political programme post May 2015. The underlining themes of reducing regulatory costs and barriers beyond what is needed to address identified consumer protection and other risks is likely to fit with the objectives of all parties.
31. Given the breadth and complexity of the issues, the range of affected stakeholders and the need for political buy-in to deliver change, developing an effective communications plan will be essential to the success of this work-stream. We intend to share evidence, analysis and position papers on an on-going basis. We will also explore the practicalities of establishing a challenge group consisting of consumer representatives, regulators, different types of practitioners and their representative bodies, academics and other commentators. Utilising an invite only on-line forum are likely to provide an efficient mechanism for facilitating discussion. This approach should draw out different viewpoints and tensions early in the debate, leaving less opportunity for unexpected challenge at the time that options are produced.
32. Indicative, high level milestones:

- **Q1 2013/14**
 - Publish work programme
 - Complete preparatory project to prioritise specific regulations for further analysis
- **Q2 2013/14**
 - Publish risk framework
- **Q3 2013/14**
 - Publish progress report
 - Publish discussion document for review of general legal advice (map of risks, protections, gaps and areas of over-regulation)
- **Q4 2013/14**
 - All stage 2 projects completed
- **Q1 2014/15**
 - Stage 3 analysis completed
- **Q2 2014/15**
 - Consultation to inform options paper
- **Q3 2014/15**
 - Options paper published

33. Choosing and implementing options is outside of the scope of this work-stream and may ultimately be a decision for Government (if a radical option is favoured).

Resource

34. The Project Team for this work currently consists of Fran Gillon/ Alex Roy as Project Leads and Chris Handford as Project Manager. Robert Cross will provide research and data collection resource. The team will be expanded to include a legal adviser, communication representative and admin support. A further project associate will be recruited to complete the Team.

Annex A: Costs and complexity of regulation: evidence, data and analysis project components

Title	Description	Lead	Source
Preparatory project	Identify regulations that would be most constructively analysed including analysis of existing data and where further data is needed	Alex Roy	Mixture of in-house and external expertise
Regulatory proportionality	Case studies to look at costs and benefits of individual aspects of regulation against the regulatory objectives and better regulation principles	Alex Roy	Mixture of in-house and external expertise
Regulatory barriers to entry, exit or merger	Economic analysis looking at regulatory barriers, proposing options for increasing market flexibility	Alex Roy	Jointly commissioned research with The Law Society
General legal advice	Testing the risks of general legal advice to individual consumers	Chris Handford	In-house
Barriers to innovation: international study of innovation and regulation	Comparative study of the development of innovation and the barriers regulation presents to adoption of innovation in legal services	Rob Cross	Facilitating academic study through collaborative funding
LSB competition data analysis	Analysis of SRA and high-street research data to establish evidence on market competition and innovation	Rob Cross	In-house
Regulatory architecture	Analysis of the direct costs imposed by LSB, the Legal Ombudsman and front-line regulators	Rob Cross	In-house
Review legislation and structure	Analysis of the legislation and structures underpinning legal services regulation to identify options for a simplified legislative structure	Fran Gillon	In-house
Review regulatory content	Analysis of regulation needed to protect against identified risks	Fran Gillon	In-house